

# **The Chinese Currency: Background and the current Debate**

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## **Abstract**

China's economic growth and increasing trade surplus with the United States has aroused heated debate on whether the Chinese currency, the Renminbi (RMB), is undervalued and whether China should revalue or float its currency immediately. To help understand the current debate, this paper provides a brief history of the Chinese currency since the founding of the People's Republic and a summary of the main arguments in the current debate.

## The Chinese Currency: Background and the current Debate

Jiawen Yang, Haiyan Yin, and Hui He

The Renminbi, or the RMB for short, is China's legal tender. The exchange rate of the currency has been fixed for the most part of the past half century with a few major discrete changes. It has remained at around 8.28 yuan to the U.S. dollar since 1994, when China adopted a managed floating exchange rate policy.<sup>1</sup> The valuation of the Chinese currency has received scant attention until recently when some people claim that the currency is undervalued at its current level.

The economic reform started in 1978 has transformed China from a centrally planned economy toward an increasingly market-oriented economy. China's average annual economic growth has been over 9% in the past two decades. At the turn of the new century, China has become a major trading nation in the world and a prominent trade partner with the United States. Due to China's comparative advantage in labor-intensive products, China is now a major source of labor-intensive manufactured products in the world. China has also become one of the largest recipients of external investment in the world in the past decade. China adopted current account convertibility in 1996 but maintained foreign exchange control on the capital account, particularly on capital outflows. The large inflows in foreign investment have contributed to a rapid buildup of China's international reserves in recent years.

China's increasing international reserves and the rising U.S. trade deficits with China have given rise to concerns over China's competitiveness in the world market and especially in trade with the United States. What has caused the U.S. trade deficits with China? Is China's currency undervalued so that it has given Chinese exporters an unfair advantage over their competitors? Some people in the business world and their representatives in the policy-making circle find ready answers to these questions amid the slowdown in the U.S. economic growth and the claim that the United States has been losing jobs in the manufacturing sector to foreign countries. People in this camp argue that RMB is undervalued and urge China to revalue or float the currency immediately. People on the opposite side of the debate argue that there is no convincing evidence that the RMB is undervalued and warn that an immediate revaluation or floating of the currency will hurt U.S. businesses and destabilize the international monetary system as well as the Chinese economy.

The objective of this paper is to provide a brief history of the RMB since the founding of the People's Republic of China in 1949 and summarize the major arguments in the current debate.

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<sup>1</sup> Many people believe that China actually followed a fixed exchange rate policy although the official policy is termed as "managed floating."

## A Brief History of the Chinese Currency

The *Reminbi*, or *RMB* in short, is China's legal tender. It translates into English as "*the people's currency*." The basic unit of the currency is *yuan*. It is issued and administered by the People's Bank of China (PBC) – China's central bank.

The use of money in China dates back to at least four thousand years ago. Cattle, grain and things of daily use such as silk, pearl, jade, tortoise shells and seashells, as well as gold and silver, had been used as media of exchange in Chinese history. Paper currencies have been in circulation for over a thousand years. With the rise of modern banks, banknotes became popular in recent history. As the victory of communist forces was in sight in China's civil war after World War II, the PBC was established on December 1, 1948. In the same year, the PBC began to issue RMB. After the founding of the People's Republic of China in October 1949, China called in other currencies and the RMB became the sole unified legal currency in China. In the next few years, China streamlined the financial and monetary system, centralized foreign exchange management, put inflation under control, and stabilized prices. On March 1, 1955 the PBC issued the new RMB to replace the old one at the rate of one to 10,000 *yuan*. This new version of the currency has remained unchanged ever since. While the *yuan* is the basic unit of RMB, two smaller units are also used: *jiao* – one-tenth of a *yuan*, and *fen* – one hundredth of a *yuan*:

One yuan = 10 jiao = 100 fen

Currently, the RMB is issued in the following denominations: one, two, five, ten, twenty, fifty and one hundred *yuan*; one, two and five *jiao*; and one, two and five *fen*.

The RMB was stable in terms of inflation for much of the 1960s and 1970s, the years in which the government set wages and prices under a centrally planned economy. Since China's economic reform began in 1978, price controls have been gradually relaxed and market forces have played an increasingly dominating role in price determination. Inflation, measured by consumer prices, climbed to double digits at times in the late 1980s and mid 1990s as economic growth accelerated, but it was quickly brought under control in both cases. China has achieved high economic growth while maintaining price stability for more than two decades since 1978.

The value of the RMB in terms of foreign exchange has maintained stability in the past few decades, except for a few discrete changes in its exchange rate with the U.S. dollar. Such stability should be attributed largely to China's external environment and its foreign exchange policy.

Immediately following the founding of the People's Republic of China in 1949, the value of the RMB was determined by price comparison of China's exports, imports, and the

purchasing power parity of foreign exchange remittance.<sup>2</sup> In 1950, the United States and other western countries imposed an embargo against China, which virtually blocked all trade between China and the rest of the world except for the Soviet bloc.<sup>3</sup> China adopted a Soviet style centrally-planned economy during the two decades since the late 1950s. China's foreign trade regime during that period could be characterized as self-reliance and "import substitution"<sup>4</sup> in response to international isolation.

In the meantime, China established a stringent system of foreign exchange control. As early as 1950, Chinese law required that all foreign exchange holdings, including those of overseas Chinese, foreign travelers and foreign embassies and missions, be deposited with the Bank of China, the sole bank authorized to deal in foreign exchange.<sup>5</sup> Like most currencies in the world after World War II, the RMB was virtually unconvertible.

As seen in Table 1, the exchange rate between the RMB and the U.S. dollar was set at 2.46 yuan to the dollar from 1955, the year when the new RMB was issued, to 1971, the year when China resumed its seat at the United Nations. Given the distortions pertaining to China's foreign trade and economic relations, the exchange rate of the RMB during this time period had little reflection of price linkages between China and the rest of the world. The RMB revalued gradually since 1972 to 1.50 yuan to the dollar in 1979. The exchange rate was set in accordance to several factors including international consumer price comparison, weighted average values of a basket of major currencies in the world, and foreign exchange settlement for foreign overseas Chinese remittance, tourist expenses, transportation and other non-trade transactions.<sup>6</sup>

The RMB exchange rate set in the 1970s was considered to be highly overvalued based on the cost of China's exports. For example, in 1979, the actual cost of earning one U.S. dollar through export was 2.41 yuan while the official exchange rate was 1.50 yuan to the dollar.<sup>7</sup> The Chinese exporter on average lost 0.91 yuan (2.41 – 1.50) for every dollar they earned through export, a loss of about 38%! In other words, the Chinese currency was overvalued by over 60% based on China's export prices. As China's foreign trade was carried out by highly centralized state-owned companies, the export losses were mitigated by the gains from imports or absorbed by the government.

China started its economic reform and open-door policy in 1978. China's foreign trade began to decentralize in 1979. In response to the pressing losses of exports, China's State Council introduced "the internal settlement rate" of the RMB at 2.80 yuan to the dollar at

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<sup>2</sup> Lin, Guijun. *On the Exchange Rate of the RMB*; University of International Business and Economics Press: Beijing, China, 1997; 228

<sup>3</sup> For discussions of U.S. economic sanctions against China and bilateral trade between the two countries, see, Yang, Jiawen; Askari, Hossein; Forrer, John; Teegen, Hildy. *U.S. Economic Sanctions Against China: Who Gets Hurt?* *The World Economy* 2004(July), 27(7), 1047-1081.

<sup>4</sup> Lardy, Nicholas R. *Foreign Trade and Economic Reform in China, 1978-1990*; Cambridge University Press: Cambridge, 1992; 16.

<sup>5</sup> Hsiao, Katherine Huang. *Money and Monetary Policy in Communist China*; Columbia University Press: New York, 1971; 24.

<sup>6</sup> Lin, op. cit. 7

<sup>7</sup> Lin, op. cit. 7

the beginning of 1980. The rate was based on China's average export cost per dollar plus a 10% profit.<sup>8</sup> This rate was used for China's trading firms to settle foreign trade earnings/payment with the government. The significance of this internal settlement rate was that, for the first time, the exchange rate of the RMB reflected to some extent the relative prices between China and its trade partners and corrected, albeit temporarily, the overvaluation of RMB. The official exchange rate, at 1.53 yuan to the dollar in 1980, was still kept for non-trade foreign exchange transactions. The coexistence of the "internal settlement rate" and the "official rate" marked the beginning of China's dual exchange rate system. The discrepancy between the two rates reflected, to a great extent, the difference in price comparisons for non-traded goods/services (the official rate) and traded goods (the internal settlement rate). Based on the costs of consumer goods and labor-intensive services, the official rate was even considered undervalued.<sup>9</sup>

The adoption of internal settlement rate first did boost the growth of exports and temporarily made the export seem profitable, but it was later not enough to compensate the loss of import.<sup>10</sup> The internal settlement rate was kept at 2.80 yuan to the dollar from 1980 to 1984 (Table 1) while the cost of export earning per dollar crawled up to 3.07 yuan in 1983 and 2.80 yuan in 1984.<sup>11</sup> At the same time, China faced external pressures for this dual exchange rate system. First, it was seen as a deviation from the requirements of the International Monetary Fund, as a dual exchange rate system is allowed only to deal with short-term, balance-of-payments problems, and IMF suggested that China return to a unitary exchange rate. Second, the internal settlement rate aroused trade complaints against China in the United States who was among the largest trading partners of China. The U.S. International Trade Commission filed cases against China's dual exchange rate system, which was believed to have increased the profitability of Chinese exports, equivalent to subsidizing exports. At the beginning of 1985, China abolished the internal settlement rate and set the official rate, which had adjusted gradually during this time period in conformity to the internal settlement rate, at 2.80 yuan to the dollar, thus ending the dual exchange rate system.

As mentioned previously, there had been tight foreign exchange controls in China since the early years of the PRC. Under this system, all enterprises, institutions, and individuals had to sell their foreign exchange to designated banks in China and to obtain allocation of foreign exchange through government planning. Starting in 1979, China started to relax some of the restrictions on foreign exchange transactions, though capital control and fixed exchange rate were still in place. New regulations allowed more banking institutions to engage in foreign exchange transactions. Bank of China no longer had the monopolistic power of foreign exchange operations. By July 2004, 3855 banks and financial institutions, including affiliates of non-resident banks, were authorized to handle foreign exchange transactions in China.<sup>12</sup>

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<sup>8</sup> Lin, op. cit. 7

<sup>9</sup> Lin, op. cit. 10.

<sup>10</sup> Lardy, op. cit. 68.

<sup>11</sup> Lin, op. cit. 7.

<sup>12</sup> Numbers are released by State Administrations of Foreign Exchange on July 20, 2004. See <http://www.safe.gov.cn/0430/glxx.htm> (accessed August 12, 2004).

As an incentive to encourage export, the Chinese government put in place a foreign exchange retention quota system in 1979. Such system allowed foreign exchange earners (mainly firms engaged in foreign trade) to retain certain percentage (quota) of their foreign exchange claims. The retention rate increased from 6.5 percent of export earnings in 1979, to 30 percent in 1983 and to 44 percent in 1988.<sup>13</sup> This retention rate later even reached 100 percent of foreign exchange income in the China's special economic zones--Shenzhen, Zhuhai, Shantou and Xiamen.

In 1980, the Bank of China, with approval of the Chinese government, started the foreign exchange swap market in Beijing, Shanghai and other major cities in China. Those who held retained foreign exchange claims could sell their foreign exchange in this market to those who were in need of foreign exchange but could not obtain it otherwise. The exchange rate for such trading was based on the internal settlement rate with a band of plus/minus 10%.

This foreign exchange swap market did not gain importance until the mid-1980s when the government substantially increased the foreign exchange retention rate to provide further incentives for exports.

More significantly, the exchange rate in this market was granted more flexibility – to be set freely between buyers and sellers.<sup>14</sup> This market driven exchange rate deviated sharply from the official exchange rate. In 1986, the exchange rate determined by the foreign exchange swap market was 6.50 yuan to the dollar while the official exchange rate was only 3.72 yuan to the dollar (Table 1). As a result, a dual exchange rate system reemerged in China. In 1993, this exchange rate in the swap market went as high as 8.70 yuan to the dollar. Meanwhile, the official exchange rate was adjusted more frequently since the late 1980s to follow the trend established by the foreign exchange swap market. As shown in Table 1, the official exchange rate was adjusted to 4.72 yuan/US\$ in December 1989 and to 5.22 yuan/US\$ in November 1990. This rate gradually increased up to 5.8 yuan/US\$ in 1993.

Despite the devaluations since 1985, the RMB was still considered overvalued in the early 1990s as the cost of China's exports kept rising and export firms suffered increasing losses. Lardy argued that during this period, though nominal exchange rate depreciated, the real exchange rate for the RMB actually increased, i.e. the Renmibi appreciated in value due to rising inflation in China.<sup>15</sup> The overvaluation was reflected in the foreign exchange swap market where the rate reached as high as 11 yuan to the dollar in 1992, a premium of about 90% over the official rate.<sup>16</sup>

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<sup>13</sup> Lardy, op. cit. 54

<sup>14</sup> It should be noted that the flexibility granted in this quota trading market did not resemble a free or floating exchange rate system, where there are no restrictions on market participants. Only those who held foreign exchange quotas were allowed to sell in this market. Purchasers of foreign exchange had to get approval for such purchase. See Lin (reference number 2) for further discussions.

<sup>15</sup> Lardy, op. cit. 114.

<sup>16</sup> Lin, op. cit. 53.

China's foreign exchange regime underwent a major reform in 1994, in tandem with the deepening of its overall economic reform. China adopted a market-based and managed floating exchange rate system, setting a goal for the currency to become convertible for current account transactions. The official exchange rate and the swap rate were merged to produce a single exchange rate, ending the dual exchange rate system again. The merged rate was set at 8.7 yuan to the dollar at the beginning of 1994, in conformity with the swap rate, a better reflection of supply and demand in the foreign exchange market. In April 1994, China's foreign exchange trading center, located in Shanghai, started operation and marked the commencement of China's inter-bank foreign exchange market.<sup>17</sup> Starting on December 1, 1996, China adopted currency account convertibility, a significant step toward fulfilling the agreements of the International Monetary Fund. The value of the RMB appreciated slightly from 8.70 yuan to the dollar in 1994 to about 8.3 yuan by mid 1995 and stayed at 8.28 yuan/US\$ since September 1998 till present (September 2004).

During the Asian financial crises that started in Thailand in 1997, major currencies throughout the region depreciated sharply against the U.S. dollar. In 1997, the depreciation of currencies against the dollar in Thailand, Malaysia, Philippines, South Korea and Indonesia reached 78%, 52%, 52%, 107% and 151% respectively.<sup>18</sup> The RMB was under immense pressure to devalue to maintain price competitiveness in the world market. Yet, the RMB remained unchanged and proved to be a pillar for stability in the international monetary system, a stance that won appreciation by China's neighbors and the policy makers in the United States and international financial institutions.

China's economic reform and open-door policy since 1978 has transformed China from a centrally planned economy to a market economy at the turn of the new century. In December 2001, China joined the World Trade Organization after 16 years of strenuous reform efforts and negotiations with other member countries. China's low labor cost and productivity improvement have made China one of the major exporters of labor-intensive manufactured products in the world. China has also been one of the major recipients of direct investment from the rest of the world. On the other hand, China still maintains foreign exchange control on capital outflows, although such control is loosening gradually in recent years. As a result, China's foreign exchange reserves increased

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<sup>17</sup> Participants in this market were limited to the 14 banks in China that were delegated by the government the right to settle foreign exchange transactions with Chinese firms. Although the dual exchange rate system terminated at the beginning of 1994, a dual market system was actually created as a result of the appearance of the inter-bank foreign exchange market. The inter-bank market was for domestic firms as it was mandatory that domestic firms conduct foreign exchange transactions with the designated banks. The foreign exchange swap market still existed for foreign invested firms. Since foreign firms were allowed to keep their own foreign exchange account and choose the timing to conduct foreign exchange transaction in the swap market, foreign firms had more flexibility in foreign exchange transaction than domestic firms. The exchange rates in these two markets were kept at par with each other through government intervention. Starting in March 1996, foreign invested firms were allowed to carry out foreign exchange transactions in both markets. In December 1998, the foreign exchange swap market was incorporated into the inter-bank market, thus ending the dual markets.

<sup>18</sup> Roubini, Nouriel; Pesenti, Paolo; Corsetti, Giancarlo. What caused the Asian Currency and Financial Crisis?. 1998; <http://www.stern.nyu.edu/globalmacro/> (accessed Feb 15, 2004).

significantly at the beginning of the 21<sup>st</sup> century. By end of June 2004, China's foreign exchange reserves reached about \$470.639 billion (Table 2).

### **The Current Debate on the RMB valuation**

China's economic growth, particularly China's growing trade surplus with the United States has triggered intense debate on the valuation and convertibility of the RMB since 2002. Is the RMB undervalued? Should China revalue its currency or let it float? These are the focal questions of the current debate. The debate was aroused by some business leaders in the manufacturing sector in the United States and their representatives in the political circle and was joined by people in the academia. One side of the debate claims that the RMB is undervalued at its current level and should be revalued or become float immediately. People on this side believe that the undervalued RMB has given Chinese exporters unfair advantages over their international competitors, contributing to the U.S. trade deficit with China and to the job losses in the U.S. manufacturing industry. Some also believe that the undervalued RMB may lead to deflation in neighboring countries and economic slowdown in the world. The opposite side argues that the RMB should not revalue or float, at least not immediately; as such a move would destabilize the world economy and the international monetary system. In this section we provide some synopsis of the current debate.

#### ***Claims That the RMB Is Undervalued***

Claims that the RMB is undervalued are based on a number of factors including international price comparison, U.S. trade deficits with China, and China's increasing foreign exchange reserves.

The Big Mac prices across countries have been cited as one indication of the RMB undervaluation. In 1986, the *Economist* began publishing a survey comparing the prices of Big Macs in a number of countries as "a rough-and ready guide to whether a currency is under- or over-valued," in the hope of making economic theory more digestible.<sup>19</sup> China was covered in the survey starting in 1992 (though omitted in 1996). According to the *Economist* survey, the average price of a Big Mac in four American cities was \$2.71 in April 2003.<sup>20</sup> The cheapest burgers were those in China (at \$1.20 each) while the dearest were those in Switzerland (at \$4.52 each). According to the survey then, the yuan was the most undervalued currency while the Swiss franc was the most overvalued.<sup>21</sup> Based on Big Mac prices, the exchange rate between the RMB and the U.S.

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<sup>19</sup> The Economist. HEADLINE: Big MacCurrencies. The Economist Newspaper Ltd., April 13, 1991; 78 (U.K. Edition Pg. 106).

<sup>20</sup> It is interesting to note that the reference for the Big Mac index—the price of a Big Mac in the United States—varies significantly even within the United States. The 1989 Economist survey found that the price of a Big Mac varied much more across cities in America than was the case in other countries. The price of a Big Mac in Manhattan (\$2.48) was about 23 percent higher than the average price for four other U.S. cities (\$2.02). Put another way, using the Big Mac standard, the average dollar for the four U.S. cities was undervalued by about 18.5 percent against the 'Manhattan' dollar.

<sup>21</sup> The "yuan" is the basic unit of Chinese currency and people often use the yuan in referring to it, even though its official name is the Renminbi, or RMB.

dollar should have been 3.65 yuan to the dollar. The actual exchange rate was 8.28 yuan to the dollar, implying that the Chinese currency was undervalued by 56 percent against the dollar.<sup>22</sup>

While Big Mac prices are not an appropriate guide for currency valuations<sup>23</sup>, policy makers and business executives have, nonetheless, used them to support their claims that China's currency is undervalued.<sup>24</sup> In a testimony before the U.S. House of Representatives, Bender, a U.S. business executive, cites the Big Mac index as proof of the RMB being undervalued.<sup>25</sup> He argued that the cheap import from China had made their product price-uncompetitive.

Other arguments hold that the RMB is undervalued based on U.S. trade deficits with China and China's accumulation of international reserves. Judging from the "rough orders of magnitude based on the gross figures in play," and China's "protracted and very large-scale official intervention of the past several years," Preeg asserted that the Chinese Renminbi was "probably in the order of 40 percent weaker."<sup>26</sup> Other economists have drawn similar conclusions, although the magnitudes of their estimates have not always been so dramatic. Goldstein and Lardy believe that so long as China maintains controls on capital outflows, runs surpluses on both the overall current and capital accounts in its balance of payments, and accumulates international reserves in large amounts; there is a compelling case that the Chinese currency is significantly undervalued.<sup>27</sup> Their preliminary estimates suggest that the undervaluation of the RMB is on the order of 15 to 25 percent. These estimates, according to Goldstein, can be obtained either by "solving a trade model for the appreciation of the RMB that would produce equilibrium in China's overall balance of payments," or "by gauging the appreciation of the RMB that would make a fair contribution to the reduction in global payment imbalances, especially the reduction of the US current-account deficit to a more 'sustainable' level."<sup>28</sup>

These estimates—the probable 40 percent of Preeg and the preliminary 15 to 25 percent of Goldstein and Lardy – have been widely quoted by U.S. policy makers and business

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<sup>22</sup> . The Economist. HEADLINE: McCurrencies. The Economist Newspaper Ltd, April 26, 2003.

<sup>23</sup> Yang, Jiawen; Bajoux-Besnainou, Isabelle. Is the Chinese Currency Undervalued?. Working Paper, Center for the Study of Globalization (CSG), the George Washington University, 2003.

<sup>24</sup> Pakko, Michael R.; Pollard, Patricia S.. For Here or To Go? Purchasing Power Parity and the Big Mac. Review, Federal Reserve Bank of St. Louis, 1996 (January/February), 78(1), 3-21.

<sup>25</sup> Bender, Jay. Testimony Before the Committee on Small Business of the House of Representatives on the Impact of Chinese Currency Manipulation on Small Manufacturers and Exporters, June 25, 2003; <http://www.nam.org/> (accessed September 28, 2003).

<sup>26</sup> Preeg, Ernest H.. Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China. Presentation at a Conference on the Dollar at the Institute for International Economics, Washington, D.C., September 24, 2002; <http://www.mapi.net/filepost/ExchangeRateManipulations.pdf> (accessed October 19, 2003).

<sup>27</sup> Goldstein, Morris; Lardy, Nicholas. A Modest Proposal for China's Renminbi. Financial Times, August 26, 2003; <http://www.iie.com/publications/papers/goldstein0803.htm> (accessed November 16, 2003).

<sup>28</sup> Goldstein, Morris. China's Exchange Rate Regime. Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology Committee on Financial Services. U.S. House of Representatives: Washington, D.C., October 1, 2003; <http://www.iie.com/publications/papers/goldstein1003.htm> (accessed October 20, 2003).

executives as proofs of the undervaluation of China's currency and used as a basis for U.S. trade policy formulations. In his testimony before the U.S. Congress on behalf of the U.S. National Association of Manufacturers (NAM), Vargo cited the 15 to 40 percent range and suggested that, given the price pressures expressed by many NAM member companies, "the market price would be toward the upper end of that range."<sup>29</sup> The Fair Currency Alliance, a coalition of U.S. industrial, service, agricultural, and labor associations, selectively used some academic research findings to support their claims that the Chinese currency is undervalued. The organization asserts that "[t]his artificial and manipulated exchange rate distorts trade and is a further threat to the eroding American manufacturing base," and that "China should promptly appreciate the value of the yuan by up to 40 percent so that U.S. manufacturers and service providers can compete on a fair and equitable basis."<sup>30</sup>

U.S. government officials have responded to such claims by exerting pressure on China to revalue or float its currency. In fact, they were among the first in arousing public attention to the issue. Former U.S. Treasury Secretary Paul O'Neill stated in November 2002 that China's exchange rate policy was "defeating the market."<sup>31</sup> Don Evans, the U.S. Commerce Secretary, warned in October 2003 that China must move faster to open its markets or face a backlash in the United States.<sup>32</sup>

U.S. lawmakers have proposed legal actions against the China's foreign exchange policy. U.S. Representative Phil English has stated that "many economists estimate that the Chinese yuan is undervalued against the dollar by as much as 40 percent."<sup>33</sup> He claims that "Beijing's artificially debased currency" has been allowing China to export to the U.S. market with a 40 percent price advantage over U.S. domestic producers. The "40 percent" estimate has thus become a frequent reference in the U.S. political arena. A bill recently introduced in the U.S. House of Representatives states that "the large and growing trade surplus of the People's Republic of China with the United States strongly suggests that the RMB is undervalued against the dollar. Recently, economists have estimated that the RMB is undervalued against the United States dollar by as much as 40 percent."<sup>34</sup> A separate bill introduced in the U.S. Senate states that "the currency of the People's Republic of China, the yuan, is artificially pegged at a level significantly below its market value. Economists estimate the yuan to be undervalued by between 15 percent

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<sup>29</sup> Vargo, Franklin J. Testimony Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services Hearing on China's Exchange Rate Regime and Its Effects on the U.S. Economy, October 1, 2003; [http://www.nam.org/Docs/IEA/27183\\_VargosTestimonytotheHouseFinancialCommitteeonChinaExchangeRate.pdf](http://www.nam.org/Docs/IEA/27183_VargosTestimonytotheHouseFinancialCommitteeonChinaExchangeRate.pdf) (accessed October 20, 2003).

<sup>30</sup> Fair Currency Alliance. Experts Agree: China's Currency is Undervalued. Brief No. 2, Washington, D.C., June 29, 2004; <http://www.prnewswire.com> (accessed August 16, 2004).

<sup>31</sup> Wall Street Journal. Pressure for a Convertible Yuan. Review and Outlook, November 20, 2002.

<sup>32</sup> Hiscock, G., CNN Asian Business Editor. Currency pressure builds on China. October 29, 2003 Posted: 0602 GMT (2:02 PM HKT); <http://edition.cnn.com/2003/BUSINESS/10/29/apec.special.yuan.eu> (accessed Feb 4, 2003).

<sup>33</sup> English, Phil. English Testifies on Chinese Currency. 2003; [http://www.house.gov/apps/list/press/pa03\\_english/chinatestimony03.html](http://www.house.gov/apps/list/press/pa03_english/chinatestimony03.html) (accessed October 19, 2003).

<sup>34</sup> H.R. 3058, The Currency Harmonization Initiative through Neutralizing Action (CHINA) Act of 2003.

and 40 percent or an average of 27.5 percent.”<sup>35</sup> The bill then proposes that, unless a certification is made by the President to the Congress that China is no longer manipulating its currency, “a rate of duty of 27.5 percent ad valorem [be added] on any article that is the growth, product, or manufacture of the People’s Republic of China, imported directly or indirectly into the United States.” In his letter to President Bush, U.S. Senator Baucus repeated the need for formal negotiations with China to address the undervaluation of the Chinese currency. He also suggested that, should these negotiations fail, the Administration should initiate an investigation under section 302 (b) of the Trade Act of 1974 into the currency manipulation issue.<sup>36</sup>

The current bashing on China’s currency has gone beyond the United States. At the early stages of the current debate, Japan’s Vice Minister for Finance Haruhiko Kuroda accused China of exporting deflation to its neighbors.<sup>37</sup> Japan’s Finance Minister Masajuro Shiokawa argued that “the fact that the (RMB’s) exchange rate is extremely low vis-à-vis the U.S. dollar may be a problem”.<sup>38</sup> Similarly, some European Union government officials also urge China to gradually loosen the Chinese RMB's peg to the dollar.<sup>39</sup>

### ***Arguments against Immediate RMB Revaluation or Floating***

People who oppose immediate RMB revaluation or floating argue that there is no convincing evidence that the RMB is undervalued and believe that a revaluation or premature floating of the currency may harm U.S. businesses in China and destabilize the world economy.

Based on analyses of U.S. – China price comparison, China’s trade, capital and international reserves, Yang and Bajeux (2003) found no evidence that the RMB is undervalued.<sup>40</sup> Inclusive of both tradable and non-tradable components in prices indices, PPP tends to overestimate the value of the RMB. China’s surpluses in trade and current accounts have been relatively small, and show no indication of currency misalignment. While China’s accumulation of international reserves appears higher than the international norm, factors other than the exchange rate (such as preferential treatment for foreign investment and control on capital outflows) have played the major role.

Robert Mundell, 1999 Nobel laureate in economics and also known as “the Father of euro” criticized the international pressure on China to revalue the yuan. According to him, “to claim that China is manipulating its currency is strange” since China has kept its

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<sup>35</sup> S 1586 IS. A bill to authorize appropriate action if the negotiations with the People’s Republic of China regarding China’s undervalued currency and currency manipulations are not successful.

<sup>36</sup> United State Senate, Committee on Finance (Max Baucus, Ranking member). Baucus Dissatisfied by Treasury Report on China Currency. News Release, Washington, D.C., October 30, 2003; <http://finance.senate.gov> (accessed Feb 2004).

<sup>37</sup> Wall Street Journal, op. cit.

<sup>38</sup> McGregor, Richard; Pilling, David. Japan presses China over weak Renminbi. Financial Times, London, UK, Aug 11, 2003; 6.

<sup>39</sup> Hiscock, op. cit.

<sup>40</sup> Yang and Bajeux , op. cit

currency fixed to the dollar since 1994.<sup>41</sup> He noted that appreciation or floating of the RMB would involve a major change in China's international monetary policy and has important consequences for growth and stability in China and the stability of Asia, and that China should float its currency only when sound financial and banking mechanisms are established. He also outlined problems which will be caused in China if the yuan appreciates by 40 percent: it will cut economic growth to 5 percent or even lower, and aggregate the country's heavy burden of non-performing loans; deflation is likely to appear and the foreign direct investment in China will be drastically cut; and it will actually lead to a weak yuan and subsequent depreciation.<sup>42</sup>

Stephen Roach, chief economist at Morgan Stanley, shared similar values. He offered three reasons to urge the China to stay in the course – to leave RMB policy unchanged.<sup>43</sup> First, he argued that the real export dynamic in China comes far more from the conscious outsourcing strategies of western multinationals than from the rapid growth of indigenous Chinese companies. Nearly two-thirds of China's foreign-driven export dynamic since 1994 is traceable to the impact of multinationals alone. So he argued that revaluation of the RMB would destabilize the very supply chain that has become so integral to new globalized production models. Second, he believed that contrary to widespread perception, China does not compete on the basis of an undervalued currency, but mainly in terms of labor costs, technology, quality control, infrastructure, the improved human capital of its work force, and a passion for and commitment to reform. Therefore, he predicted that if China were to revalue the RMB upward by 10%, its exports would suffer minimal loss of market share. Third, he mentioned that China has consistently reiterated its long-term commitment to opening its capital account and making its currency fully convertible. He argued that until there is greater progress on the road to financial reforms, it would be entirely premature and risky for China to float its currency. Besides these most compelling reasons, Roach argued that there are also several other consideration against an RMB revaluation: an intensification of imported deflationary pressures for a Chinese economy that is just now climbing back out of deflation; a possible outbreak of bubbles in other asset markets, especially property; and a signal to market speculators that the RMB is now “in play.”

Roach's argument that a stable Chinese currency is critical to the international supply chain in the integrated world economy is echoed by many U.S. multinational firms. According to a report by the Financial Times, significant sections of U.S. business, “which once lobbied Washington to force change in Japan, are displaying little interest in taking on the undervalued RMB as an issue.”<sup>44</sup> While many small enterprises and textile manufacturers are suffering from competition with China, large US companies such as GM, GE, Du Pont and Yum Brands, which includes KFC, are thriving on the mainland.

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<sup>41</sup> Zhang, Lu. Experts Discuss Currency. China Daily (North American Ed.), New York, N.Y., Nov 4, 2003; 5.

<sup>42</sup> Zhang, op. cit.

<sup>43</sup> Roach, Stephen. The Scapegoating Of China. Global Economic Forum, Morgan Stanley, July 14, 2003; <http://www.morganstanley.com/GEFdata/digests/20030714-mon.html#anchor0> (accessed February 14, 2004).

<sup>44</sup> McGregor, Richard. International Economy: Thriving US companies ignore China trade surplus issue. Financial Times, Aug 07, 2003; 2.

Even Goldstein and Lardy, who believe the RMB is undervalued, are not in favor of immediate floating of the currency.<sup>45</sup> They have proposed a “two-stage currency reform” for China. The first step should be medium-size (15% to 25%) revaluation of the yuan, a widening of the currency band (to between 5% and 6%, from less than 1%), and a switch from a unitary peg with the dollar to a three-currency basket peg, with weights of roughly a third each for the dollar, euro and yen. Step two should be adoption of a managed float, after China has strengthened its domestic financial system enough to permit a significant liberalization of capital outflows.

Those who are in the policy-making or political circles are not unanimous in urging China to revalue or float its currency immediately. Former U.S. Federal Reserve Chairman Paul A. Volcker warned that revaluing the yuan would invite a frenzy of speculation that could be “destructive to economic development.”<sup>46</sup> He recommends that China “ought to stick with its policy of maintaining stability with the U.S. dollar.” The current Federal Reserve Board Chairman Alan Greenspan warned against forcing China to boost the value of its currency. He acknowledged that “competition from abroad has risen to a point at which our lowest-skilled workers are being priced out of the global labor market”, but the answer “is education and retraining, not protectionism or adopting the position of anti-globalization forces who favor ‘employing the power of state to override the outcomes arrived at through voluntary exchange’.”<sup>47</sup> He argued that a rise in China’s currency “would be unlikely to have much, if any, effect on aggregate employment in the United States, but a misaligned Chinese currency...could have adverse effects on the global financial market and hence indirectly on U.S. output and jobs.”<sup>48</sup>

Similar views were also shared by Eisuke Sakakibara, Japan’s former vice-finance minister and once known as “Mr Yen”, who argued that a floating yuan may lead to a disastrous result in Asia and even in the world.<sup>49</sup> He estimated that contrary to the US manufactures, about 70 percent of the Japanese firms believe appreciation of RMB will harm them and yuan should remain stable.<sup>50</sup>

International organizations have given their verdict and recommendations on the Chinese currency. The United Nations states in its annual report on trade and development that it is important that China retain its autonomy and option to use the exchange rate, if need be, to prevent serious disruptions in certain sectors of its economy.<sup>51</sup> In its release of 2003 Article IV Consultation with the People's Republic of China, the International

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<sup>45</sup> Goldstein and Lardy, op. cit.

<sup>46</sup> Clifford, Mark L. China's Exports: How Low Can Prices Go?. Business Week, December 2, 2002; [http://businessweek.com/magazine/content/02\\_48/b3810081.htm](http://businessweek.com/magazine/content/02_48/b3810081.htm) (accessed November 30, 2002).

<sup>47</sup> Fuquay, Jim. Fed Chairman Warns Against Forcing China to Boost Value of Its Currency. Knight Ridder Tribune Business News, Washington, D.C., Dec 12, 2003.

<sup>48</sup> Fuquay, op. cit.

<sup>49</sup> Zhang, op. cit.

<sup>50</sup> Zhang, op. cit.

<sup>51</sup> United Nations. Trade and Development Report, 2002: Chapter V: China’s Accession to WTO: Managing Integration and Industrialization. United Nations Conference on Trade and Development, Geneva; [http://www.unctad.org/en/docs/tdr2002ch5\\_en.pdf](http://www.unctad.org/en/docs/tdr2002ch5_en.pdf) (accessed December 1, 2002).

Monetary Fund (IMF) concluded that “most Directors noted that there is no clear evidence that the RMB is substantially undervalued at this juncture.”<sup>52</sup> As for RMB revaluation, IMF Directors argued that a currency revaluation would not by itself have a major impact on global current account imbalances—particularly given China's relatively small share in world trade. Nevertheless, they considered that the rapid build-up of foreign exchange reserves indicates some pressure on the exchange rate and imposes costs on the Chinese economy, especially difficulties in preventing excessive monetary expansion. In this context, “directors observed that increased flexibility of the exchange rate over time would be in the best interest of China”.

Whether the Chinese government has manipulated its currency to its own advantage is among the issues of the current debate. John Snow, the current U.S. Treasury Secretary, while arguing that a flexible, market-based, exchange rate is appropriate for China and efforts should be made to urge the Chinese to adopt a flexible exchange rate, testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs<sup>53</sup> that China's global current account surplus had declined and China had had a peg over a long time period during both upward and downward pressures on the currency. In its Report to Congress on International Economic and Exchange Rate Policies in October 2003, the U.S. Treasury stated that the Chinese government didn't manipulate its currency.<sup>54</sup>

Commenting on the debate about the flexibility of Chinese currency, an article carried in *The Economist* in 2003 observed that the Chinese currency was under attack – not from speculators but from finance ministers who thought it was unreasonably cheap.<sup>55</sup> The article stated that a few years ago, as one currency peg after another fell victim to the Asian financial crisis, the world's economic policymakers urged China to hold fast to its fixed rate of 8.28 yuan to the dollar. Today, finance ministers around the world are urging China to turn the yuan loose, or to repeg it at a less competitive rate. It said in this article that “having sold the Chinese on the virtues of rigidity, they are now preaching the merits of flexibility. China's currency peg is no longer seen as an anchor holding the region's economy in place, but as a deadweight holding the rest of the world's economies back.”

### **Concluding Remarks and Future Research Topics**

The significance of the current debate on the Chinese currency is multi-fold. First, the attention that has been given to a developing country's currency is unprecedented. This reflects the growing eminence of the Chinese economy. Second, it has been unique that a developing country's currency is urged to revalue instead of devalue. The standard advice for countries that undertake rapid trade liberalization is to devalue in order to

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<sup>52</sup> IMF Concludes 2003 Article IV Consultation with the People's Republic of China. Public Information Notice (PIN) No. 03/136, November 18, 2003; <http://www.imf.org/external/np/sec/pn/2003/pn03136.htm> (accessed 2/6/2004).

<sup>53</sup> Snow, John. Testimony of Treasury Secretary John Snow before the Senate Committee on Banking, Housing and Urban Affairs, JS-953, US Treasury, Office of Public Affairs, October 30, 2003.

<sup>54</sup> Report to Congress on International Economic and Exchange Rate Policies, JS-954, US Treasury, Office of Public Affairs, October 2003.

<sup>55</sup> *The Economist*. Mercantilism with Chinese characteristics; China's cheap currency. Tuesday, August 12, 2003.

prevent deterioration in their balance of payments.<sup>56</sup> Third, what happens to the RMB when it becomes fully convertible will be critical both practically and theoretically in the economic development of the emerging markets. So far there have been few successful stories for currencies of developing countries – one after another fell upon financial liberalization. Will China be different?

The current debate has been limited to some very practical issues of immediate concern to those in selected business areas and their representatives in the policy circle. Very few academic studies, either theoretical or empirical, on far-reaching issues have appeared. We believe further research in the following areas will substantially enrich our understanding of the Chinese currency and its role in the international monetary system in the future:

First, detailed investigation of the value of RMB according to purchasing power parity. The existing literature suggests that valuation of currencies of low-income countries based on PPP has a bias toward undervaluation. This is due to the inclusion of non-traded components in the price indices. Further investigations into how traded and non-traded goods affect the RMB valuation will shed light on the currency proper values.

Second, further investigation of other factors that may affect the value of RMB. These factors include GDP growth, trade and investment flows, and viability of the financial sector, capital flights, and the international environment.

Third, analysis of other countries' experience in foreign exchange management. For the RMB to become a convertible and international currency, the experience of Japan and Germany may provide some insights.

Fourth, analysis of currency experiences of other emerging markets. Can China avoid the same pitfalls that many developing countries had fallen into upon financial liberalization? What lessons do these experiences have to offer for China?

Fifth, analysis of possible impact of RMB convertibility on China's financial stability. How sensitive is the Chinese financial infrastructure to external shocks upon full convertibility? What impact will full convertibility have on China's financial markets? As many emerging markets suffered from financial crises after full convertibility, how will China's economy react to its currency's full convertibility? What adjustment should China make to make the transition period smoother?

Sixth, analysis of possible impact of RMB convertibility on the rest of the world. What are the financial linkages between China and the rest of the world? Will the RMB's convertibility have a significant impact on global financial markets? If China does suffer a financial crisis following full convertibility, will there be any contagious effect to the rest of the world?

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<sup>56</sup> United Nations, *op. cit.*

**Table 1: RMB Exchange Rate (Yuan per U.S. dollar)**

Year	Official Rate	Year	Official Rate	Internal Settlement Rate 1980-84	Swap Rate 1980-93
1952	2.617	1978	1.580		
1953	2.617	1979	1.500		
1954	2.617	1980	1.530	2.80	2.80
1955	2.460	1981	1.750	2.80	2.80
1956	2.460	1982	1.920	2.80	2.80
1957	2.460	1983	1.980	2.80	2.80
1958	2.460	1984	2.800	2.80	2.80
1959	2.460	1985	3.200		3.20
1960	2.460	1986	3.720		6.50
1961	2.460	1987	3.720		6.50
1962	2.460	1988	3.720		6.00
1963	2.460	1989	4.720		5.70
1964	2.460	1990	5.220		5.50
1965	2.460	1991	5.430		5.93
1966	2.460	1992	5.750		6.80
1967	2.460	1993	5.800		8.70
1968	2.460	1994	8.450		
1969	2.460	1995	8.320		
1970	2.460	1996	8.300		
1971	2.460	1997	8.280		
1972	2.240	1998	8.280		
1973	2.020	1999	8.280		
1974	1.840	2000	8.280		
1975	1.970	2001	8.280		
1976	1.880	2002	8.280		
1977	1.730	2003	8.277		

Data sources:

*Official rate:*

1. 1957-2002 from IMF: International Financial Statistics, end of period data.
2. 1952-1956 from Nicholas Lardy (see reference number 4, page 148).
3. 2003 from China State Administration of Foreign Exchange, ([http://www.safe.gov.cn/Statistics/rmb\\_03.htm](http://www.safe.gov.cn/Statistics/rmb_03.htm) accessed Feb 1, 2004)

*Internal Settlement Rate:* Lin (see reference number 2, page 7).

*Swap rate:*

1. 1980-1984, 1987-1990 are estimates from Lardy (see reference number 4, page 57-66).
2. 1993 data obtained from "Headline: The Trouble with China Trade". Global News Wire – Asia Africa Intelligence Wire. Aug 2, 2003. LexisNexis Academic. <http://web.lexis-nexis.com/universe/printdoc> (accessed Feb 17, 2004)
3. 1985, 1991, 1992 data are author's own estimation based on Lin (see reference number 2, page 41-53).

**Table 2: China's Foreign Exchange Reserves (Billions of U.S. dollars)**

Year	Reserves
1984	8.220
1985	2.644
1986	2.072
1987	2.923
1988	3.372
1989	5.550
1990	11.093
1991	21.712
1992	19.443
1993	21.199
1994	51.620
1995	73.597
1996	105.049
1997	139.890
1998	144.959
1999	154.675
2000	165.574
2001	212.165
2002	286.407
2003	403.251
2004	470.639

Note: Data for 2004 is for the end of June.

Data source: China State Administration of Foreign Exchange, <http://www.safe.gov.cn> (accessed August 8, 2004)