# JOINT ECONOMIC COMMITTEE

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## PRC'S PEGGED EXCHANGE RATE CONTRIBUTES TO GLOBAL IMBALANCES

Since 1995, the People's Republic of China (PRC) pegged its currency, the renminbi, to the U.S. dollar at the rate of $1 equals 8.28 yuan.[1]

If the foreign exchange value of the renminbi begins to increase (i.e., $1 becomes less than 8.28 yuan), the PRC's central bank must purchase U.S. dollars with yuan. Such U.S. dollar purchases increase the supply of yuan and reduce the renminbi's foreign exchange value until it again equals the pegged exchange rate. Simultaneously, the PRC's central bank buys U.S. Treasury and U.S. Agency debt securities with the U.S. dollars that it acquires. This increases the PRC's foreign exchange reserves.[2] If the foreign exchange value of the renminbi begins to decline (i.e., $1 becomes more than 8.28 yuan), this process is reversed.

Determined to retain power after the events of 1989, the Chinese leaders sought to redefine the Communist Party as the provider of economic growth and improving living standards for the Chinese people. The leaders devised an export-led, inward foreign direct investment-dependent development strategy that could deliver rapid economic growth given the PRC's serious interrelated structural problems of its domestic economy.

An undervalued pegged exchange rate is integral to this strategy. Economists estimate that the renminbi is now undervalued by between 15 percent and 40 percent. An undervalued renminbi reduces the real wages of Chinese workers and lowers production costs in the PRC. Thus, an undervalued renminbi encourages foreign multinational firms to invest in the PRC and shift production to their Chinese affiliates.

The PRC's development strategy has been successful. From 1990 to 2004, the PRC's average real GDP growth was 9.3 percent. The PRC's share of the world's goods exports has expanded dramatically. From 1994 to 2004, the PRC's average net foreign direct investment inflow was equal to 4.1 percent of GDP.

To run large current account surpluses and large investment inflows simultaneously, the PRC must accumulate U.S. dollars and dollar-denominated assets to maintain its undervalued pegged exchange rate. By December 31, 2004, the PRC had acquired $610 billion in foreign exchange reserves.

Under the pegged exchange rate policy, the real value of the renminbi has generally tracked the real value of the U.S. dollar. Since 2002, the real values of the U.S. dollar and the renminbi have trended down together.

Because of these decreases, governments in other major Asian economies feared that their domestic firms and their domestic affiliates of foreign multinational firms would lose export market share in Europe and North America to Chinese firms and Chinese affiliates of foreign multinational firms.[3]

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[1] Renminbi means "The People's Currency." In the United States, we use the dollar to refer to both the U.S. currency and the U.S. unit of account. The renminbi is the name of the PRC's currency, while the yuan is the name of the PRC's unit of account. Technically, one should use renminbi to refer to the PRC's currency as a concept (like the U.S. dollar) and yuan to refer to amounts (like five dollars) or circulating notes (like a ten-dollar bill) in renminbi.

[2] When foreign exchange reserves are measured in terms of U.S. dollars.

[3] Other major Asian economies include Hong Kong SRA, India, Indonesia, Japan, South Korea, Malaysia,

Consequently, central banks in these other major Asian economies increased their aggregate foreign exchange reserves to $1.8 trillion on December 31, 2004. This limited the increase in the real values of their currencies against the real values of U.S. dollar and the renminbi.

The foreign exchange reserves of the PRC and other major Asian economies are excessive by any standard. The PRC's foreign exchange reserves were equal to 37.0 percent of its GDP on December 31, 2004. Similarly, the aggregate foreign exchange reserves of the other major Asian economies were equal to 24.5 percent of their aggregate GDP on December 31, 2004. In contrast, the foreign exchange reserves of the United States were equal to a mere 0.4 percent of GDP on December 31, 2004.

Through massive interventions in foreign exchange markets, other major Asian economies were generally successful in thwarting significant appreciations in the real value of their currencies. Without such massive interventions, the real value of the currencies of most major economies in the rest of the world increased significantly.

Beginning in 2002, Asian central banks accumulated foreign exchange reserves at a historically unprecedented rate. One result was a net inflow of $717 billion into the United States between 2002 and 2004. This inflow slowed the decline in the real value of the U.S. dollar.

The U.S. Treasury recently concluded, "China's fixed exchange rate is now an impediment to the transmission of price signals and international adjustments, and imposes a risk to its economy, China's trading partners, and global economic growth."[4] Because of the PRC's policy, the United States is running somewhat larger current account deficits than it would run based solely on the private decisions of individuals and firms around the world.

Moreover, the PRC's pegged exchange rate policy is distorting expectations about future global prices and rates of return on investments. Thus, the PRC's pegged exchange rate policy is causing underinvestment in some sectors and overinvestment and malinvestment in other sectors in countries around the world.

The artificially high real value of the U.S. dollar is shifting investments from the tradable goods sector toward the non-tradable goods and services sectors. As Federal Reserve Governor Ben S. Bernanke observed, "much of the recent capital inflow … has shown up in higher rates of home construction and in higher housing prices" while "the growth in export-oriented sectors such as manufacturing has been restrained."[5] This distortion extends beyond the United States to other countries that have not intervened massively in foreign exchange markets.

Overinvestment and malinvestment may be occurring in the PRC's tradable goods sector. To lesser extent, similar distortions may be occurring in other major Asian economies.

Unless the PRC changes its undervalued pegged exchange rate policy, these global imbalances will fester. Their inevitable correction will become more costly to the PRC, the United States, and the rest of the world in terms of lost employment, production, and wealth.

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the Philippines, Singapore, Taiwan, and Thailand. Please note that there are other major economies such as Russia and Turkey that are, in part, on the Asian continent that are not included under this definition of other major Asian economies.

[4] U.S. Department of the Treasury, "Report to the Congress on International Economic and Exchange Rate Policies," (May 2005): 11.

[5] Ben S. Bernanke, "Remarks at Homer Jones Lecture," (April 14, 2005). Found at http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm