The Global Impact Of China's Currency Policy: U.S. And Beyond

Peggy J. Crawford, (E-mail: pcrawfor@pepperdine.edu), Pepperdine University
Terry Young, (E-mail: tyoung@pepperdine.edu), Pepperdine University

ABSTRACT

Since the yuan is pegged to the dollar, the U.S. and Chinese economies have become inter-connected in a myriad of ways. This study examines the global implications of this relationship.

INTRODUCTION

The dollar rebounded slightly in May 2005 from lows against the euro, pound, and yen set in late 2004. President Bush and Secretary of the Treasury Snow continued to state their support of a strong dollar, but noted that a weaker dollar does make U.S. goods cheaper overseas and should drive down the troubling trade deficit. Although the trade deficit between the U.S. and Europe, and the U. S. and Japan has been fairly stable, the trade deficit with China has continued to grow and has been a major cause of the current record trade deficit. The increasing deficit is blamed by some on the fact that the Chinese government pegs its currency to the dollar and the exchange rate, despite the general loss in the value of the dollar, has stayed constant at 8.28 yuan to the dollar.

As the dollar weakened, the Chinese government purchased record amounts of U.S. government securities to prop up its currency. Some experts suggest that if the yuan was allowed to float against the dollar, it would increase in value by as much as 30 percent. This would result in a sharp increase in the price of Chinese goods exported to the U.S. and a sharp drop in the price of U.S. goods imported into China.

The actions of the Chinese government have led to an interconnection between the U.S. and Chinese economies. This paper will address the following questions:

1. What caused the dollar to depreciate?
2. How has the relationship between the yuan and the dollar impacted the U.S. economy?
3. What is the impact on the Chinese economy of pegging its currency to the dollar?
4. How has the relationship between the yuan and the dollar impacted economies in the rest of the world – particularly Europe?
5. What would be the implications for the U.S. economy if the Chinese government floated its currency and reduced its purchase of U.S. government securities?

THE DEPRECIATION OF THE DOLLAR

The dollar has lost 20 percent of its value against the pound, and 50 percent of its value against the euro since 2001. It has, however, fallen by a more modest 17 percent against a broad basket of currencies which includes the yuan.[1] The dollar began its fall during the economic stall following 9/11. But, as the economy rebounded, the dollar continued to fall – the opposite of what economic theory would suggest. The continuing decline appears to result more from doubts about the U.S. economy's future than from confidence in the eurozone, where growth remains sluggish and the prospect of moving toward a pro-market policy still seems remote. The sharp decrease in value

seems to be a reaction to the stubborn U.S. trade deficit and a troubling U.S. budget deficit, and their potential impact on future growth.

The cumulative U.S. trade deficit set an annual record during 2004 of $617.7 billion or more than 5 percent of GDP.[2] As the U.S. economy picked up steam, the deficit continued to grow driven by higher oil prices and growing demand for foreign goods.[3] A country with a trade deficit can compensate for the deficit by attracting foreign capital. That is, if a country can attract a large enough inflow of foreign capital, it can import more and still finance its trade deficit. The size of the trade deficit has made the U.S. dependent on attracting foreign capital

The brief budget surplus of the Clinton Administration has been replaced by the deficit of the Bush Administration. President Bush cut taxes to stimulate the economy, and increased government spending on Homeland Security and the wars in Iraq and Afghanistan. The deficit passed $420 billion in 2004 and forecasts suggest it will remain at high levels even though economic growth should increase tax revenues. To finance this deficit, the U.S. Government will have to issue an estimated $500 billion worth of Treasury securities.[4] The size of the budget deficit has made the U.S. dependent on attracting domestic and/or foreign capital.

Traditionally, capital flowed into the U.S. through direct foreign investment, such as Daimler Benz's investment in Chrysler, or portfolio investment, such as buying the stocks and bonds of U.S. companies. These assets were purchased to take advantage of the economy's faster productivity growth and, hence, higher return. Increasingly, however, capital flows not from foreign private investors, but from Asian central banks, which have become major purchasers of U.S. Treasury securities. The central banks have increased their dollar debt in an effort to curb the appreciation of their own currencies against the dollar, and protect the competitive prices of their exports to the U.S. market. Japan and China were major purchasers of U.S. government securities in 2004. The governments of Thailand, Korea, Singapore and other Asian countries have followed similar strategies but on a smaller scale.[5]

Previous falls in the value of the dollar have pushed American bond yields up as foreign creditors demanded extra reward to compensate for the increased currency risk. However, this depreciation in value has so far been painless with bond yields staying remarkably low. Ten-year Treasury notes, for example, yielded 4.1 percent on average during the first half of 2005, slightly less than the yield on comparable European bonds. Low interest rates appear to have distorted financial markets: the dollar remains too high and America's cost of capital remains artificially low. This allows America to continue borrowing freely without the usual warning sign of rising bond yields.

IMPACT ON THE U. S. ECONOMY

The U.S. economy has rebounded from the 2001 recession strongly and consistently, partially driven by interest rates at 40 year lows. This growth has not been matched in Japan and Europe, particularly Germany. Germany has done little to reform the rigidities of its labor market. Wages remain one of the highest in the world and an obstacle to job creation. German businesses are stifled by rules and regulations which limit their ability to compete. Germany, as a member of the European Monetary Union, has relinquished the ability to use monetary tools to stabilize its economy. The European Central Bank, not the individual countries, sets interest rates for the eurozone. European economic policies, including relatively high interest rates, seem contradictory to the needs of an economy facing limited growth or recession. The situation is aggravated by the appreciation of the euro against the dollar. An appreciating currency is equivalent to a tighter monetary policy because higher relative prices lead to a downturn in demand – the policy to fight inflation, not low growth or recession.

There are some encouraging signs in the Japanese economy after more than a decade of stagnation. Deflationary pressures seem to be easing, the stock market appears to be rallying, consumer spending seems to be increasing, and corporate profits are up. However, analysts warn against too much optimism. Prices continue to decline particularly in computer products and parts, the unemployment rate hovers at near-record rates, and banks face an estimated $295 billion in bad loans.[6] These problems may be surfacing as growth has recently slowed. Economists predict GDP growth of only 1.6 percent in 2005.

The results of the slow growth in Europe and Japan have limited the impact of the fall in the value of the dollar on exports. Even though the trade deficit narrowed in December 2004, with exports increasing by 3.2 percent and imports staying relatively flat, the trade deficit still grew 24 percent in 2004.[7] Secretary of the Treasury John Snow stated that foreign countries are not growing fast enough to create the domestic demand necessary to help boost U.S. exports. He contended that Europe and Japan needed to do more to stimulate growth and that this would be a major item on the agenda at the meeting of the world's seven wealthiest countries in February 2005.[8]

On the other side, U.S. consumer demand for imported goods continues to increase. This is caused partly by the fact that many goods demanded by consumers, such as televisions, computers and name-brand clothes are no longer produced in the U.S. In addition, the American market is so important to many foreign companies that they adjust their prices and cut their profit margins to maintain market share. This is reflected by the fact that the dollar has fallen by about 16 percent on a trade-weighted basis over the last three years, but prices have only increased by about 3.5 percent.[9]

Until recently, the international financial system has been operating on a de facto dollar standard with sovereign debt often denominated in dollars. In essence, the U.S. prints much of the world's reserve currency. This has allowed the U.S. to enjoy virtually an unlimited line of credit denominated in its own currency, and supported by the rest of the world. However, investors' confidence has been shaken by corporate scandals and doubt as to the reliability of U.S. corporate accounting. In addition, the Federal Reserve (FED), in an effort to stimulate growth in the U.S. economy, kept interest rates low – lower than euro rates – until June 2004 when they began to raise them "at a measured rate". The low interest rates stimulated consumers to refinance their mortgages, lower their monthly mortgage payments, increase their disposable income, and thus stimulated consumer borrowing for a wide range of products from homes to automobiles.

However, low interest rates have discouraged foreign private investors, and increased the importance of investment by Asian central banks, who are not interest rate sensitive, in picking up the slack. In order to support their currencies against a falling dollar, China and other Asian central banks have been major participants in the Treasury securities market purchasing more than $1 trillion of U.S. government securities.

The U.S. relies on almost $4 billion of foreign inflow of capital each day. If money from abroad started to dry up, economic theory would suggest that interest rates would have to increase to attract foreign investment. In other words, the U.S. Treasury would have to make its debt more attractive to hold by increasing the return to investors. This would hurt not only U.S. consumers, businesses, and governments who would see their cost of borrowing increase, but also other economies that rely on U.S. growth. Interestingly in November 2004, foreign purchases of Treasury securities plunged 75 percent. In December 2004, Japan sold Treasury securities and China slowed its purchases. But, interest rates did not increase. Instead, the interest rate on the benchmark 10-year Treasury note decreased from 4.35 percent in November to 4.22 percent in December. The dollar did react as expected to the news of a slowdown in foreign purchases. It fell 0.7 percent against the yen and 0.4 percent against the euro.[10]

What does all this mean for the future of the U.S. economy? The falling dollar will probably not be enough to reduce the trade deficit. Meaningful reduction will only come when American consumers decrease their demand for foreign goods. The cause of America's growing taste for imports may not be unfairly cheap production in China – usually named as the culprit – but its low savings rate. The current-account deficit basically reflects America's lack of saving, by both households and the government. In 2004, savings averaged 0.9 percent of after-tax income, the lowest level ever.[11] Ideally, the U.S. will now tighten its monetary and fiscal policies, boost saving, curb domestic spending, and reduce imports. A rise in interest rates increase the opportunity cost associated with spending rather than saving.

THE YUAN AND THE U. S. ECONOMY

China's accumulation of foreign exchange reserves is largely concentrated in U.S. Treasury bills. This has had two major implications. First, it allowed the U.S. government, companies, and individuals to borrow at low rates and increase their expenditures fueling growth in the U.S. economy. And second, it spurred the widening U.S. current account deficit and caused the value of the dollar to fall.

The interconnection between the Chinese and U.S. economies has limited inflation in the U.S. in two ways. First, the production of cheap products in China allows the U.S. to import inexpensive products and increases U.S. buying power. And second, the purchase of Treasury securities by Asian banks has artificially lowered the cost of capital in the U.S. Since foreigners are willing to support U.S. consumption, inflation remains low. This allowed the FED to leave interest rates at low levels for an expanded period of time.

Chinese policy has made it difficult for the U.S. to cut its balance-of-payments. Given that the yuan is unofficially pegged to the dollar, a depreciating dollar has not slowed U.S. imports from China nor is it likely to narrow the U.S. trade deficit with China. The trade deficit with China increased from $6.2 billion in 1989 to $160 billion in 2004.[12] China now accounts for one-quarter of the U.S. trade deficit. The media generally focuses on the massive flow of imports from China; however U.S. exports to China also have been rising significantly and account for 20 percent of the increase in total U.S. exports.

Most analysts believe that the Chinese yuan is currently undervalued, given its rising reserves and large surplus on its "basic balance" – the sum of its current account surplus and the net inflows of long-term capital, such as foreign direct investment.[13] Exports from China to the U.S. are now 5.7 times the value of imports – a gap that many experts say is caused by China's refusal to float its currency and allow the price of its exports to rise.[14]

IMPACT ON THE CHINESE ECONOMY

Actions and events that impact the Chinese economy are carefully scrutinized because of the growing importance of China in the global financial system. In theory, countries that experience fast and high economic growth should see their real exchange rates climb. A free interplay of demand and supply would make the yuan rise and spread the burden of the dollar's adjustment. However, China is trying to resist the market forces by intervening heavily in the currency markets to protect its exports.

WEIGHING THE IMPACT OF A FIXED YUAN

The decision by the Chinese government to peg the yuan to the dollar has both positive and negative implications. Following is a summary of both.

The cons include:

1. The rate of return on U.S. Treasury securities is artificially low causing excess borrowing and spending by American consumers, businesses, and governments. The Chinese central bank cares little about the financial return on their dollar reserves. Their sole concern is to keep the exchange rate stable to promote domestic economic growth.
2. The fixed yuan creates excess liquidity in China which fueled asset-price bubbles (as in the real estate market). Until 2002, almost all of the balance-of-payments surplus could be accounted for by foreign direct investment (FDI). But last year, FDI equaled just 40% of the surplus. So although Beijing has forced banks to curb lending to restrain growth, there are still traces of overinvestment due in part to speculative funds from abroad.[15]
3. China has limited its ability to use monetary policy to cool its overheated economy. The government should increase the cost of borrowing which would have down its economic growth. Yet, the interest stayed at 5.3 percent for nine years until China's central bank recently announced an increase to 5.6 percent. This action caused a stir in the financial market. But rates can not be raised much higher than U.S. rates. Otherwise, even more dollars would flow in as Chinese companies boosted borrowings of cheaper money from abroad.[16]
4. Countries in the rest of the world, including the U.S. continue to protest what they see as unfair competition due to the artificially low yuan. Global protectionist sentiments are rising and some are questioning China's admittance to the World Trade Organization.[17] In a thinly veiled reference to China, the finance ministers attending the January, 2005 meeting of the G-20 stated, "more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility".[18] In the U.S., protectionist sentiment has been

rising with the U.S. current account deficit with China. Senator Charles E. Schumer introduced a bill in September 2003 calling for American tariffs against Chinese imports until the yuan is allowed to float.

5. Although the prices of commodities such as oil and steel have increased, Chinese manufacturers have absorbed the increase in the cost of production in order to maintain or increase their market share. The weaker yuan has increased the cost of materials, but manufacturers have not passed the increase along. They have, instead, decreased their profit margins. At the same time, other Asian countries are not be able to appreciate their currencies due to competitive pressures from China.

The pros include:

1. The fixed yuan has been good for Chinese manufacturers since the decrease in the value of the dollar has made their exports more competitive against European goods.

2. The fixed yuan has kept the Chinese export machines humming at the expense of other countries with floating currencies. China's exports to the rest of the world have become even more competitive with a low yuan.
3. The weak yuan and low labor cost has enticed more foreign direct investment (FDI) in China. China has been the biggest destination of FDI in the past years.

CHINA'S RELUCTANCE TO FLOAT THE YUAN

As China weighs the pros and cons of a convertible currency, it remains reluctant to float the yuan. The government is aware that economic security is essential for its political stability.

The Chinese economy is undergoing a painful transition as Beijing continues to restructure agriculture and privatize its state owned enterprises (SOEs). The 1997 Asian financial crisis and years of deflation in China led its government to pursue an easy monetary strategy. The growth was sustained through subsidies to money losing SOEs. This led to $1.8 trillion in outstanding bank loans, which is equal to 140% of its GDP. All four major banks hold 70 percent of China's total savings of $3 trillion. However, they are all technically insolvent given their huge portfolio of non-performing loans.

The privatization of the state owned enterprises led to massive unemployment, which is currently running at about 20 percent. The government has to ensure that this surplus labor is absorbed into the economy. Given the government's export-led growth strategy, the manufacturing sector must employ hundreds of millions of Chinese to produce goods for export to the rest of the world, and the U.S. is the biggest market.

While the Chinese government agrees that it needs to float the yuan, it is unlikely to unshackle its currency until they are able to fix the fragile banking sector. If capital controls are relaxed, speculators could move their money offshore where they can earn a higher return. Locally, its citizens could switch their yuan savings into dollars or Hong Kong dollars, possibly causing the collapse of the banking system.

The government has taken several incremental steps to reform its fragile banking system. Since 1998, Beijing has recapitalized the banks and taken over some of the bad loans. The central bank recently eliminated the ceiling on banks' lending rates, allowing banks to charge riskier borrowers more. Slowly, it is allowing companies and individuals to exchange their yuan for foreign currency, which may help offset the effects of speculative inflows of funds.

The People's Bank of China (PBOC) Vice-Governor Li Ruogu said that Beijing "had already made a host of fundamental preparations" for moving toward a more market-based, flexible exchange rate. This policy will slowly liberalize the exchange rate. He added that the PBOC intends to keep the yuan "basically stable." In short, China will introduce more flexibility into its currency system on its own terms. And the changes will be incremental, within Beijing's time frame, and designed to keep China as competitive as ever.[19] Given its shaky financial system and the

problems experienced by Thailand, South Korea, and Russia after they dismantled capital controls, China isn't inclined to let foreigners dictate its currency policies.

International political pressures are forcing China to gradually make the yuan convertible. China is likely to link the yuan to a trade-weighted basket of currencies rather than just to the U.S. dollar. The wider band would allow for some appreciation. Letting the yuan appreciate by 15 percent and then fluctuate within a band would probably cool the speculation and move the currency closer to a market rate, suggests Nicholas R. Lardy of Washington's Institute for International Economics.[20] Although these steps are not great leaps forward, they will move towards a more flexible currency policy. At this stage, China's competitiveness and strong economy will be able to withstand these changes.

IMPACT ON EUROPEAN ECONOMIES

European officials are frustrated by America's lack of concern for the dollar's slide, China's reluctance to float the yuan, and the disproportionate burden this is imposing on the euro. There is also a deeper policy rift between Europe and America over a different sort of burden sharing. America accuses the eurozone of implementing overly tight economic policies and not pulling its weight in supporting global growth. Europeans, on the other hand, protest lax monetary and fiscal policies in the U.S. which they believe are perpetuating the twin deficits.[21]

The dollar's exchange rate with the euro is considered the world's single most important price given its huge potential economic consequences. The depreciation of the dollar against the euro has both positive and negative implications. Following is a summary of both.

The pros include:

1. A strong euro lowers the cost of oil and other commodities priced in dollars for European companies. This is offset somewhat by the fact that passenger aircraft, such as Airbus, are priced in dollars.
2. A strong euro improves Europe's terms of trade. Cheap imports from China not only increase retailers' income, but boost consumers' spending power. Rising consumption may be linked to strong euro.
3. A strong euro reduces the costs of carrying debt denominated in dollars.
4. A strong euro can boost domestic demand, through the easing of monetary policy. Lower interest rates should also boost Europe's feeble domestic demand, which has long been a big drag on eurozone economies.
5. A stronger euro provides European companies the opportunity to buy U.S. companies cheaply. However, merger and acquisition activities have so far been limited.

The cons include:

1. A strong euro places an unfair burden on the eurozone companies. Because China has refused to let the yuan appreciate against the dollar, most of the burden of upward adjustment on other currencies against the dollar has been fallen on the euro.
2. The strong euro may delay needed critical structural reforms. The continued soaring euro could throw the Continent into serious recession, and delay its needed financial and societal reforms.
3. The strong euro increased the import of Chinese consumer goods into Europe. Trade between Europe and China had been fairly balanced, but it started to show an imbalance.
4. The strong euro makes European exports more expensive relative to American ones, cutting into Europe's global sales. Across the board, European firms lost between 8-10 percent of revenue growth because of the weakness of the dollar last year.
5. Repatriated profits have lost value. European companies receiving dollar denominated revenues report weaker results in euros. EADS, Bertelsman, SAP blame the dollar for weaker profits.

Although manufacturers may be hurt in the short term by the rise of euro, the eurozone's economy as a whole should benefit. Most European businesses are able to cope with a stronger euro because of strong global growth. Any currency losses are compensated by the increase in global activity. The impact of a high euro on the domestic

manufacturing is muted given the strong inter-eurozone export market. To illustrate, Germany, France and Italy are major trading partners with each other. However, companies with a global reach, such as German carmakers and French luxury-goods firms, are susceptible to exchange rate fluctuations. In addition, many European companies have built "natural hedges" by moving some production abroad, at the expense of eurozone output, eg. M-class Mercedes are produced in Alabama.

Most analysts believe the dollar's long-term direction is down. A weaker dollar implies higher future interest rates. This should slow growth in the U.S. economy, as consumer and business expenditures decrease. At the same time, Europe may be hurt by a decrease in their exports due to their soaring currency. The global economy will be able to manage the drop in dollar as long as the fall is gradual. If the value of the dollar suddenly took drops, the rest of the world could be dragged into a global recession.

CONCLUSION

Supporting a strong dollar has been an economic goal for most presidential administrations. The value of the dollar affects a wide range of factors including trade balances, capital flows, inflation, growth rates, profits, share prices, and interest rates. The Bush Administration, faced with a growing trade and budget deficit, seems to have adopted a more relaxed view. They appear willing to accept a depreciated dollar to reduce the trade deficit. However, the dollar's declining value has had limited impact on the trade deficit because China pegs its currency to the dollar to protect the price of its exports to the U.S. and increase the price of U.S. exports to China.

China is facing political pressure to allow some flexibility in its currency policies. China's policymakers, while showing some inclination towards flexibility, appear determined to do it on their own terms, and seem likely move towards an exchange rate pegged to a basket of currencies. Changes will probably be made on an incremental basis for economic and political reasons. Economically, China's shaky financial system, and massive unemployment make quick change impossible. Politically, change is normally slow because of consensus decision-making, and the fear of any social and political unrest caused by widening income inequalities and unemployment.

By artificially propping up the value of the dollar, Asian governments are delaying the necessary adjustment of global imbalances. It encourages both China and America to pursue risky economic policies. Excessive liquidity is causing the Chinese economy to overheat, and Asian central banks are subsidizing American borrowing costs, encouraging more consumer profligacy, and so allowing the current-account deficit to continue to grow. The burden of economic adjustment has so far fallen unfairly on Europe. If not managed carefully, the inevitable correction may be all the more painful, and China may not be the only loser in the currency-intervention game.

ENDNOTES

1. *The Economist,* December 4, 2004, p. 9.
2. *The New York Times,* February 11, 2005, p. C1.
3. *The Financial Times,* May 13, 2004, p. 1.
4. *The Los Angles Times,* January 26, 2005, p. A1.
5. Peggy J. Crawford and Terry Young, "The Twin Deficits: A Looming Crisis?" *The Graziadio Business Report*, summer 2004.
6. Peggy J. Crawford and Terry Young, "Inflation to Deflation and Back?" *The Graziadio Business Report,* spring 2004.
7. *The Los Angeles Times,* February 11, 2005, p. C3.
8. *The Los Angeles Times,* January 13, 2005, p. C3.
9. *The Los Angeles Times,* December 13, 2004, p. A19.
10. *The New York Times* February 16, 2005, p. C9.
11. *Business Week,* December 27, 2004, p. 39.
12. *The New York Times,* January 12, 2005, P. C4.
13. *The Economist,* February 5, 2004.
14. *The New York Times,* February 14, 2004, p. B3.

15. *Business Week,* October 18, 2004, p. 45.
16. *The Economist,* November 6, 2004, p. 12.
17. *The New York Times,* January 25, 2005, p. A1.
18. *The Los Angeles Times,* January 22, 2005, p. C3.
19. *Business Week,* November 22, 2004, p. 65.
20. *Business Week,* October 18, 2004, p. 45.
21. *The Economist,* February 5, 2004.

NOTES