On the use of economic arguments in the political debate about RMB undervaluation

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1 Introduction

In the presidential election of 2012 the Republican candidate Mitt Romney took a tough stance against the currency policy of the People's Bank of China: 'Unless China changes its ways" he stated, " on day one of my presidency I will designate it a currency manipulator and take appropriate counteraction.'[1]

The consequences of globalization in terms of off-shoring and loss of manufacturing jobs have been a recurrent issue in American politics over the last decades. Still, from an outside perspective it is a curious fact that a seemingly technocratic and complicated issue like China's currency policy is given such an important role in US politics.

In this paper we try to answer the question if the Chinese currency policy deserves such a central position in the United States' foreign policy debate given its actual economic importance and the United States' possibilities to influence it.

In the chapter "**??**", we will explore the underlying economic theory, focusing on standard textbook economic models. What is the importance of the exchange rate? What does it mean for a currency to be undervalued? And how do economists know if and by how much a currency is undervalued? We will then portray the academic debate among economists about China's currency policy.

In the following chapter "The political debate", we will look at the political debate: How has it developed in the US over the last ten years? What are the arguments brought forward and who are the main participants? On the Chinese side, what are the political arguments for (and against) current Chinese monetary policy?

In the third chapter "Diplomatic options" we will discuss the issue from a diplomatic point of view: What are the diplomatic options that the USA have to put pressure on China to change its foreign exchange policy?

In the final chapter "Conclusion" we will bring together the economic, political and diplomatic threads to answer the question how economics inform the diplomatic and political debate about China's foreign exchange policy.

[1] Guardian (2012).

2 Economics

The exchange rate between two currencies is based on how much it costs to buy a fixed amount of one currency with the other. This price depends on the demand and the supply of each currency on the money market.
Macroeconomic theory postulates, that for every two currencies at every moment, there exists a balanced exchange rate, called the *equilibrium exchange rate*.[2] There is a number of different theoretical methods for defining the equilibrium exchange rate. We can broadly group them in two approaches:

- Estimates based on purchasing power parity (PPP)
- Estimates based on macroeconomic balance ideals

The basic idea of PPP is to declare the exchange rate as ideal, at which with a given amount of money you could buy exactly the same goods in two countries. A famous example of such an approach is The Economist's Big Mac Index.[3] If a Big mac costs 1 USD in the US and 5 RMB in China, the ideal exchange rate would be 1 to 5. You can then calculate the deviation of the actual exchange rate to the ideal equilibrium exchange rate. Of course this is also done with a more diverse basket of goods than a Big Mac.
The second group takes a macroeconomic indicator as a basis, and measures how much a country diverges from a level that is considered normal. The most prominent of such features is current account. The current account is the difference between a country's total exports and its total imports. If a country exports more than it imports it has a current account *surplus* - China, Germany, Japan and Switzerland are all current account surplus countries. If a country imports more goods and services than it exports, it has a current account *deficit* - the USA are currently the most prominent and by far the biggest deficit country. To define a normal level some economists pick an absolute balance, e.g. zero. Others, based on the difference between emerging and advanced economies allows for a fluctuation of around 3% as to lie within normalcy. The equilibrium exchange rate is now defined as the exchange rate, at which the current account would move down (or up) to the previously-defined normal level. This idea of an ideal exchange rate becomes important when politicians talk about China as a "currency manipulator". If the market for currencies was working like a standard market of goods, with firms and private persons being able to buy and produce money, all

[2](Krugman und Wells, 2008, pp. 505).
[3]http://www.economist.com/markets/Bigmac/Index.cfm

exchange rates would always be at their equilibrium rate. However, money is not a normal tradable good, and the production of money for every country is controlled by their national bank. A national bank can print a discretionary amount of money in their own currency.[4] But how much money should a national bank print? This decision is a matter of *monetary policy*.

2.1 Monetary policy

The standard monetary policy of western countries is to define a target for inflation, normally around 2%. The national banks are mandated to control the supply of money such that this target is met. Currencies of these countries are then freely traded and their exchange rate fluctuates with varying demand.

Nations can also chose to exercise a tighter control of the value of their exchange rate. This is very common: Some national banks even use their money supply to 'peg' their currency to another, so that exchange rates are fixed. For example, the Swiss National Bank (SNB) offers every vendor of an euro CHF 1.20 in exchange. Since the SNB controls the money supply of Switzerland, it will never run out of CHF. As a consequence the euro will never be lower than 1.20 until the SNB changes its exchange rate policy. In this case monetary policy becomes an *exchange rate policy*: Instead of focusing on inflation, the goal of the policy is to control the exchange rate.

A strong incentive for a national bank to maintain a *low* exchange rate is to boost exports. Take a typical tradable good as an example: A watch produced in Switzerland sells at a fixed price in Swiss Francs (CHF). If for one euro you get 1.50 CHF exchanges for 0.7 Euro, a watch worth 1000 CHF costs 666 Euro in Germany. If the value of the Swiss Franc rises, so that one CHF, the price of the same watch is now 1000 euro in Germany — this watch is now a much less competitive good on the world market.

However this behaviour forces trading competitors to take similar steps in order to protect their own exports, which easily leads to a situation where countries are competing to devaluating their currencies in order to export more, a policy known as beggar thy neighbour. After such an episode during the Great Depression in the 1930's, the behaviour was internationally recognized as nonbeneficial for all partners involved and international institutions were instantiated to create a set of rules and enforce that these rules are enforced by all countries that are members of the respective organizations. The most prominent of these today are the IMF (International

[4] The process is somewhat more complicated than printing bank notes, but the effect is the same for the purposes of this section.

Monetary Fond), the WTO (World Trade Organization) and - in Europe - the EU (European Union).
With the notions of the equilibrium exchange rate and monetary policy in mind we can now restate what it means for a currency to be undervalued: A currency is undervalued when its exchange rate is held below the equilibrium exchange rate by a national bank by means of monetary policy.

2.2 Is China manipulating the RMB exchange rate?

Chinese goods have been very competitive on the world market during the last ten years and Chinese exports have more than quadrupled since China joined the WTO in 2001.[5] It is this stunning growth that has prompted accusations against China: The People's Bank of China have followed a policy that helped keeping the Chinese currency, the renminbi (RMB) undervalued.[6]

2.2.1 Arguments in Favor

Some critics of China's monetary policy make argument that the RMB is undervalued by pointing out that the Chinese national bank did everything a bank would do were it manipulating the exchange rate.
So how would a National Bank keep a rate below its equilibrium rate? According to textbook economics this can be done in three ways:[7]

1. The government can shift supply and demand for its currency by intervening on the foreign exchange market. By buying foreign exchange and selling the local currency the government can drive the price of foreign exchange up and the price of the local currency down.

2. The government can shift supply and demand by means of monetary policy, namely by keeping interest rates low. Lower interest rates mean lower returns for foreign investors. If foreign investors refrain from investing locally, the demand for the local currency decrease. which drives the price of the local currency down.

3. The government can impose foreign exchange controls, forbidding foreigners to buy the local currency. This reduces the practical demand by outlawing it, which makes the currency price go down.

[5] of St. Louis Economic Research (2012).
[6] The renminbi is also abbreviated to CNY, reflecting the name of the basic unit of the Renminbi, the Yuan.
[7] (Krugman und Wells, 2008, pp. 514)

According to Goldstein and Lardy this is exactly what the People's Bank of China has been doing for a decade:[8]

1. The Chinese government has intervened on the foreign currency market on a massive scale: It has been buying foreign currencies, mainly US Dollars (in the form of US government debt) in exchange for RMB to the amount of 10% of its GDP, i.e. 10% of the value of all goods and services produced in China.

2. Interest rates in China are relatively low: When the interest rate is adjusted for inflation, the so called *real* interest rate has actually been negative for the most part since 2006.

3. China imposes foreign exchange controls that limits the amount of RMB that is sold to international investors or other governments.

As a result, critics of China's exchange rate regime say, China's export sector has become unfairly competitive.
Adding further to the pile of evidence, critics argue, is China's practice of *sterilization*.[9] If the Chinese government buys foreign currency paying with RMB, it is increasing the amount of RMB in circulation in the economy.[10] According to standard economic models an increase in the money supply means that the currency has less value and (all other things equal) prices go up, leading to inflation.[11] As a result, goods produced in China would become more expensive on the world market not due to currency appreciation, but because production costs (e.g. wages of Chinese workers) rise with inflation. According to this model, even though the People's Bank of China (PBC) keeps the *nominal* exchange rate fixed, the *real* exchange rate would increase.[12] Inflation would offset the competitive advantage of Chinese goods in the long run and cancel out the effects of the lower exchange rate for the RMB.
The People's Bank of China is taking measures that are suited to prevent a appreciation in real terms: It is *sterilizing* the money inflow, mainly by raising reserve requirements for Chinese commercial banks. Raising reserve requirements limits the amount of money the commercial banks can issue as

[8] (Goldstein und Lardy, 2008, pp. 40).
[9] Humpage und Mowry (2010) and (Xiaoyi, 2011, p. ?).
[10] In economical jargon it is expanding the *monetary base*, what (other things equal) leads to an increase in money supply
[11] (Krugman und Wells, 2008, pp. 432).
[12] (Krugman und Wells, 2008, p. 509).

loans, therefore 'extracting' money out of the economy. This in turn limits inflation and prevents the *real* value of the RMB to rise.
By raising reserve requirements, China has prevented about 40% of the money inflows of entering the monetary base since 2003.[13]
Despite these measures, China has seen some inflation during the last ten years.[14] Even so, China clearly has been taking measures to fight inflation and was thereby lowering its *real* exchange rate. Accordingly, while inflation should compensate an undervalued nominal exchange rate in the long run, China is accused of procrastinating 'the long run' by preventing inflation to happen.
To sum up, critics argue that China is enacting policies that keep the RMB undervalued on two levels. The nonimal exchange rate is kept low by economic policy which usually causes inflation making the real exchange rate rise. To prevent this, China is negates this effect by sterilizing the money inflow, thus doubly preventing the RMB from gaining value.

2.2.2 Arguments against

There are a variety of arguments supporting the legitimacy of Chinese monetary policy. One stance is to deny the importance of the exchange rate. A different approach is to deny that China is indeed manipulating the exchange rate in the first place.
The first mentioned argumentation points out that China's export success can be explained with other factors than the exchange rate. Different authors point to different reasons:
One factor is *labor arbitrage*:[15] Chinese workers are willing to work at lower wages than workers in importing countries. Importantly, accepted wages are not only lower in absolute terms but also in terms of purchasing power: A typical wage in China allows for a lower standard of living than a typical wage in an industrial country, thereby allowing Chinese firms to produce with much lower labor costs, both absolute and relative.
Another explanation is that Chinese producers profit from very cheap energy and land rents.[16] These markets are not liberalized and prices can therefore be strongly influenced by government policy. For Chinese officials on the local as well as on the federal level GDP growth is a major ambition. This

[13] Humpage und Mowry (2010).
[14] Humpage und Mowry (2010).
[15] This factor was pointed at by Xu Mingqi of the Institute of World economy of the Shanghai Academy of Social Sciences in a talk to our class on September 4 2012.
[16] (Huang, 2010, pp. 25).

makes them maintain energy and land use prices that are cheaper on average than in industrial countries as well as other emerging economies.
Another factor explaining strong Chinese exports has been introduced in 2005 by Ben Bernanke, shortly before he was named chairman of the US Federal Reserve:[17] The *saving glut hypothesis*. According to Bernanke a special series of circumstances has lead to an exceptionally high saving rate, i.e. the percentage of income that is saved. Partly due to the lack of social security institutions and to the One-Child-Policy, the saving rate of Chinese households is among the highest in the world - in 2007 it was 53% as opposed to for example Switzerland's 17,5%.[18]. These savings drive down interest rates in China and allow the local producers to access very cheap loans, which in turn allows them to expand production.[19]
A similar approach is to point out the symmetry of the world market. While China is running a current account surplus, the US in turn run a current account *deficit*, importing much more goods than exporting. According to Wyplosz, this deficit is caused by the low saving rate of US households and the budged deficit of the US government.[20] Instead of trying to explain China's export success with the alleged undervaluation of the RMB, one could with equal justification explain the US deficit with the *over*valuation of the US Dollar.
What all approaches mentioned have in common is the insistence that there is no need to invoke the alleged RMB undervaluation to explain China's success on the export market. A different argument does not deny the importance of the exchange rate but states that each of the practices taken by the PBOC may also have legitimate purposes. China is not the only country that pegs its currency to another currency - we already mentioned that Switzerland is doing so. A fixed exchange rate has the advantage of giving firms and consumers certainty about the future value of a currency.[21] Lowering interest rates to spur growth is also a tool widely used by National Banks worldwide. On top of that, limiting inflation is considered to be one of the main goals of *any* national bank.[22] Finally, many other countries - among them Japan, Germany and Switzerland - run current account

[17]Bernanke (2005).
[18](Yang, Zhang et al., 2011, pp. 20) and Office (2012)
[19]This explanation is also favoured by (Wyplosz, 2010, pp. 41) and (Reisen, 2010, p. 65).
[20](Wyplosz, 2010, pp. 39-40).
[21](Krugman und Wells, 2008, p. 515)
[22]China's capital controls might be the only exception, but their importance pales against that of China's foreign exchange reserves.

surpluses that are as big as China's, relative to their GDP.
This puts us in a situation where one camp argues that China has strong exports driven by an undervalued currency and that the proof of this undervaluation lies in the policies implemented by the government. On the other side we have a camp that counters these arguments, pointing out that there could be plenty of reasons why Chinese exports are strong, and that every policy measure implemented by the Chinese government is legitimate in it's own right.
If only there were a way to objectively measure by how much a currency is under- or overvalued we might be able to stop discussing intentions and debating cause and effect. Fortunately many economists have worked hard at coming up with just this.

2.2.3 A possibly objective measure

In order to convincingly argue for or against the China's economic policies we need an economic model that objectively tells us *by how much* the RMB is under- or overvalued. There is a substantive body of research trying to do just that.
The most prominent estimates are based on the macroeconomic balance approach described above. In particular a 2008 report by the International Monetary Fund outlines three macroeconomic balance indicators that can be used to estimate the disparity between the real and equilibrated exchange rate[23]:

- **The current account approach** looks at projections of a country's current account and tries to estimate how much the exchange rate would need to be adjusted for it to stabilize within a certain level.
- **The reduced-form equilibrium real exchange rate approach** tries to estimate the equilibrium directly based on the annual change in the current account as well as a number of trade indicators.
- **The external sustainability approach** tries to find the exchange rate that would stabilize the change in the current account of a country to within a certain level.

These techniques have been used by Cline and Williamson in their yearly policy brief on equilibrium exchange rates of the Peterson Institute for International Economics, a private research institution whose researchers have

[23] **?**Lee2008.

taken a leading role in criticizing Chinese exchange rate policy during the last decade.[24] Their estimates are based largely on the first and third methods proposed by the IMF. They designate that debt and trade surplus above 3% of GDP is abnormal and try to calculate how much the exchange rate would have to change to bring the current account within a normal treshold. In 2009 their results showed that the Chinese RMB was undervaluated by 21.4%. Additionally they found the US dollar to be 17.4% percent overvaluated, futher contrasting the value gap between the two currencies.

However, in a similar approach using international trade flows Cheung, Chinn and Fuji find diverging results for 2009.[25] According to their calculations the RMB might be undervalued by as much as 50%, but they do not find the deviation to be statistically significant and being highly volatile for small variations in the data. In a newer paper in 2010, reviewing several different estimates they stress the fact that large uncertainties surround all the estimates.[26]

Estimates based on the PPP approach again deliver varying results, from the RMB actually being *over*valued by 5% to a 20% undervaluation for 2009, according to Cheung, Chinn and Fuji.[27] Other researchers also find huge swings in different estimates, with the RMB being undervalued by up to 47%.[28] One problem of PPP approaches is, that the price level in emerging economies is generally lower than in advanced economies. According to the so called Balassa-Samuelson effect, this is mainly because services and non-tradable goods (e.g. a haircut or a restaurant meal) are much cheaper in emerging economies.[29] There are attempts to take account of such effects and calculate a revised PPP equilibrium exchange rate, but the results are mixed: The above-mentioned variations depend largely on different assumptions in the calculating models.

The range of estimates — from 5% overvalued to 50% undervalued — clearly illustrates why estimating an equilibrium exchange rate is a difficult problem. How we pinpoint the equilibrium and according to what factors we measure the divergence is a question which is vague enough that these measures lose their objective quality and become just another tool in the debate.

[24] Cline und Williamson (2009) and Cline und Williamson (2012).
[25] Cheung, Chinn et al. (2009).
[26] Cheung, Chinn et al. (2010).
[27] (Cheung, Chinn et al., 2010, pp. 82).
[28] (Subramanian, 2010, pp. 72).
[29] (Frankel, 2010, pp. 57).

3 The political debate

The RMB was pegged to the Dollar from 1994 at a rate of 8.28 RMB per Dollar until 2005. Then it appreciated at about 6% per year, before the appreciation came to a halt in the aftermath of the financial crisis. The RMB appreciated again from mid 2010 up to now.
Following this movement of the RMB exchange rate, this chapter will depict the political debates about RMB appreciation in the USA and China.

3.1 The political debate in the USA

The history of the political debate in the USA about RMB undervaluation can roughly be seen in four phases:
It started shortly after China had joined the World Trade Organization WTO in 2001. As a member of the WTO, China gained access to Western markets (and vice versa) within an international regulatory structure ensuring free trade and banning protectionist measures. Critics in the USA argued that China was taking unfair advantage of these rules and bending them to China's own advantage. At the core of the critics of Chinese foreign exchange policy were the American labor unions.[30] Organized labor in the US has been critical of free trade in general, at least since the North American Free Trade Agreement (NAFTA) had been signed into law in 1993, and due to the ongoing decline of manufacturing in the US. In addition, the decline of products 'made in USA' was contrasted with ever more products labelled 'made in China', as a result of China's export surge. Labor unions held the position that this decline was at least partly due to employers shifting production from the US to China. In 2004, the Assistant Director for International Economics at AFL-CIO, the umbrella federation for US unions, stated before the US Congress:

> [. . .]it is clear that the Chinese governments manipulation of its currency, violation of international trade rules, and egregious repression of its citizens fundamental democratic and human rights are key contributors to an unfair competitive advantage.[31]

Speaking of currency *manipulation* and an *unfair* competitive advantage, the AFL-CIO Director makes clear that she does not consider China's exchange rate policy as purely technical but as an issue where political action

[30](Levy, 2011a, pp. 14)
[31]Lee (2004).

of the USA is needed to protect the interests of American manufacturing workers.

In the early 2000's, labor unions were largely alone in their call for action against China's currency policy. In a 2003 issue of *The international economy magazine* over thirty international analysts from business and academia shortly answered the question 'Is China's currency dangerously undervalued and a threat to the global economy?'.[32] Most US analysts held the view, that even if China's currency was undervalued, export surplus did not come at the cost of US manufacturing. In their view, manufacturing was inevitably moving from the US to emerging economies. If the RMB exchange rate had been manipulated, it had been so at the cost of other emerging economies like India or Vietnam. Correspondingly, experts representing other East Asian countries in the *International economy magazine* tended to a more harsh view of China's exchange rate policy. In addition, US experts pointed out the benefits of cheap Chinese exports for American consumers, who could choose from a growing variety of cheap consumer products like toys and electronics. Thus, cheap Chinese exports helped keeping US inflation low.

In 2005 the *saving glut hypothesis* brought forward by Ben Bernanke opend a new line of criticism on China's export surplus. In this view, the Asian export surpluses posed a threat to global economic stability. However, since this critique came in a time of worldwide economic prospoerity, and since the RMB had started to appreciate against the US Dollar anyway, the critique was not initially drawn into the political spotlight.[33]

During the *Great Recession*, the financial and economic crisis that started with the burst of the US housing bubble in 2006, the critique of China intensified. As the view prevailed that the crisis was partly due to lack of demand and excess of savings worldwide, prominent economists like Paul Krugman - writing for the New York Times - joined the critics.[34] In addition, the continuous appreciation of the RMB had stopped in 2008. As a result, the critique became more heated on a political level. With each American election, a new batch of politicians paraded their toughness on China's economic policies promising tougher measures and severe consequences. The most prominently displayed examples are of course American presidential candidates during election years. Both Mitt Romney and Barack Obama made remarkably similar points during the elections of 2008 and 2012 respectively.

[32] IEM (2003).
[33] (Levy, 2010, p.16).
[34] Krugman (2009).

At a speech in 2008 to the "Alliance of American Manufacturing" an interest organization representing a part of the US manufacturing industry, Obama stated (speaking about China):

> Look, here's the bottom line. You guys keep on manipulating your currency and we are going start shutting off access to some of our markets

. Romney one the other hand stated several times during the 2012 election to label China as a currency manipulator from day one in office.[35] These points are both reiterating an argument based on the trade ramifications of a purportedly undervalued RMB.

The debate in the US reached a climax in the spring of 2010 when the Obama administration had been long overdue to release the biannual treasury report. The report is mandated to label China as a currency manipulator if there is sufficient reason to do so, and considerable pressure was mounting from both politicians and pundits to do just that. After delaying the report several months, China was finally not officially accused of manipulating their currency by the report, a move that only increased the heated debate on the subject and made many republicans accuse Barack Obama of being weak on China.

Looking back from the end of 2012 where the RMB has largely appreciated the political debate of the last century looks mostly like a storm in a glass of water. Especially when Romney under the 2012 election still maintained that China was a currency manipulator. Looking back at the decade between 2002 and 2012 in american politics, much was said about China and very little was done. The lack of concrete results however probably has just as much to do with the other side of the issue: The Chinese.

3.2 The political debate in China

Political discussions of the RMB issue in China are of course much less public and transparent than the debate in the USA. It is the State Council in Beijing, headed by the Premier Minister - until 2012 this was Wen Jiabao - that sets macroeconomic policy, including the exchange rate regime. This policy ultimately has to be approved by the Politburo Standing Committee, headed by Hu Jintao until 2012.[36] Instead of following the debate we will focus on different motivations and interest groups that might influence this political sphere.

[35] Obama (2008) and Romney (2012).

[36] Naughton (2008).

The interest group most directly concerned by the exchange rate policy are Chinese exporting firms. Exporters generally have a strong interest in a weak RMB, since it makes their products cheaper and thus more competitive on the world market. The export industry is mainly located in eight provinces along the Chinese coast. Exporting firms make up only 5-6% of Chinese employment, but their influence is amplified by their enormous profits and their close relations to the government, especially through politicians of said provinces.[37]

Also in favor of expansive monetary policy are many representatives of local Chinese government. Their main legitimization — and sometimes their main source of income — is economic growth.[38] Growth is also the only legitimization of the central government in Beijing, giving a strong rationale for growth-spurring monetary policy, including a low RMB exchange rate.

As mentioned in the section on economics, one problem in maintaining a low exchange rate is inflation. Inflation can be politically disruptive, spurring popular discontent. Accordingly, controlling inflation is one of the main macroeconomic goals of the central government.[39]

Officials concerned with inflation are joined by officials aiming at balancing the Chinese economy more towards domestic consumption, and away from the production surplus. Pushing for this are more traditional 'communists' who feel Chinese workers did not profit enough from the economic boom, but 'balancing the economy' has by now become an official part of economic policy.[40]

Chinese nationalism is a third factor that joins inflation control and growth as a motivation force. The perceived humiliations of the 19th century together with China's lackluster economic performance up until recent times has fueled a political will to reinstante China in its rightful place.[41] This has lead to a political atmosphere where much weight is put on not appearing weak in confrontations with western powers.

In terms of economic policy these factors are all in part making China less open to suggestions on economic policy from the US. The economic motivations lead China do disregard foreign concerns while the national pride makes it unlikely for a Chinese politician to appear as if he or she were taking orders from abroad.

With these motives in mind we can now identify the two turning points, in

[37](Breslin, 2010, p. 202).

[38](Levy, 2011a, pp. 19).

[39]Naughton (2011).

[40]Wang (2011).

[41]Hughes (2006)

2008 and in 2010, of the RMB exchange rate. Before the year 2008 China saw spectacular growth rates. The main concerns then were preventing inflation and balancing the economy - the concerns of exporters were marginal and China let the RMB slowly appreciate against the US Dollar. In spring 2008 the global economic crisis hit exporters hard and growth was coming to a halt. At the same time a new economic team at the State Council was enacted in which according to Barry Naughton Wang Qishan, a official friendly to exporting firms, was the new strong man.[42] This team decided a pause in RMB appreciation and pegged the RMB to the US Dollar at about 6.8 Yuan per Dollar. In addition, the new policies included tax reliefs and easier access to loans for exporting firms. With this stimulus, the exporting sector was soon thriving again and by 2010 inflation again became the major concern.[43] The peg was loosened and since 2010 the RMB is appreciating again. Although the appreciation is slower than between 2005 and 2008, the appreciation in real terms is even faster, due to Chinese inflation and *de*flation in most Western countries.

The picture that is apperant here is a China focused on their own internal affairs, adjusting their econonmic policy with respect to their primary motivations of growth and stability. It's a picture of a China that seems largely unfazed by outside pressures. To explore this dynamic we will need to look at the diplomatic exchange between China and the US.

[42] Naughton (2008).

[43] Naughton (2011).

4 Diplomatic options

The diplomatic debate between the US and China takes many different shapes. While the dialogue is defined by continuous attempts from the US to convince China to appreciate the RMB, the methods span from passive domestic policy statements to efforts of using international bodies to persuade China to change their economic policies.
In this section we will explore the different means of diplomatic pressure that has been in use during the last decade. For each method we will look at the following characteristics:

1. What is the specific reasoning brought forth in the economic debate?
2. Where does the debate take place?
3. What is the (potential) Chinese reaction?

4.1 Unilateral action

The most discussed and most direct option for the US would be to label China a 'currency manipulator'. The US Treasury department is mandated in writing a biannual report on whether trading partners manipulate their currency.
Labeling China a 'currency manipulator' does not do anything in itself - it merely amounts to an international insult. But with labelling a country a currency manipulator the US Treasury Department has the mandate to

> *[...] take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar [...] to eliminate the unfair advantage.*[44]

So far, the US Treasury Department refrained from labelling China a currency manipulator, much to the dismay of members of US congress, especially those representing states with strong manufacturing. In 2009 a bill was proposed by the republican senator Timothy Ryan of Ohio, aiming to introduce a tariff with the stated purpose:

[44]Treasury (1988).

> *To amend title VII of the Tariff Act of 1930 to clarify that countervailing duties may be imposed to address subsidies relating to a fundamentally undervalued currency of any foreign country.*[45]

Because the low RMB has the same effect as a tariff on US goods, the reasoning goes, the US should reply with the same means, imposing a tariff on Chinese goods. The bill passed the House but was not put to a vote in the Senate, sharing the fate with other similar bills proposed in Congress.
The USA have in fact tried the proposed method before: In 1971 Nixon decided to instate trade tariffs against goods imported from Japan and Germany after having pressured them into appreciating their currency in vain. The tariffs forced Japan to appreciate the Yen against the Dollar shortly after, but the overall economic gains for the US are debatable.[46]
Had the US decided to follow through with tariffs they would have faced two problematic scenarios. First of all, it is most likely that China would have responded to US tariffs by implementing equal measures, leading to a trade war where both countries would be creating trade walls to the detriment of both economies.[47] Secondly, a trade tariff would be in violation of WTO regulations of free trade and the US would face threats of penalties.

4.2 Multilateral action

The alternative to facing China alone with tariffs is to take action via one of the international economic organizations where both China and the US are members. If both countries have signed treaties preventing them from conducting their economic policies in some unfair manner it would be possible for the US to seek penalties against China and in this way force them to stop the practice.
There are three international bodies that govern multilateral economic relations: The G20, the International Monetary Fund (IMF) and the World Trade Organization (WTO). Through all of them the USA could try to influence or condemn Chinese monetary policy.
The G20 is a group of 20 finance ministers and central bank governors from 20 major economies that try to promote economic cooperation and a venue for discussions on the international finance system. Pushed by the USA several attempts at making the participating leaders pledge their allegiance

[45] Ryan (2009).
[46] Kuroda (2004).
[47] Levy (2010).

to economic policies that would prevent countries from manipulating their currencies. However the strongest statement so far was reached at the 2009 Summit in Pittsburgh where the leaders agreed '*to adopt the policies needed to lay the foundation for strong, sustained and balanced growth in the 21st century*'. Later attempts at further defining exactly what is covered by 'balanced' have failed.[48]

An alternative approach would be to address the IMF, whose stated goal it is to stabilize exchange rates. In fact Dominic Strauss Kahn, then head of the IMF, has publicly stated that the RMB was undervalued in 2009, and the IMF has repeated this sentiment with slight modifications since then.[49] Despite these statements no action has been taken by the IMF to regulate or penalize China. The IMF lacks the means to influence donor countries that aren't dependent on it for borrowing money.[50]

In China the IMF labeling the RMB as undervalued elicited a strong response. After the label of the RMB as 'moderately undervalued' in 2011, the chief of the Institute of International Finance at the East China Normal University, Huang Zeming conceded that ' *it is certain that the RMB exchange rate has been underrated, but there is no fixed standard that could be used to test whether the appraisal method is proper*', arguing that the conclusions made by the IMF are meaningless.[51]

Lastly the US could address the World Trade Organization, an organization that is deliberately set up to supervise and liberalize international trade. Two WTO agreements possibly qualify to condemn the Chinese monetary policy: Article XV(4) of the General Agreement on Tariffs and Trade (GATT) and the Agreement on Subsidies and Countervailing Measures (ASCM).[52] Regarding the GATT the US could argue that Chinese monetary policy has the same effects as a tariff. Regarding the ASCM the US could argue that Chinese monetary policy amounts to a subsidy for exporting firms. But most scholars of trade law doubt such argumentation would be successful. Both the GATT and ASCM are very specifically on tariffs and subsidies - the ASCM even contains a closed list of what counts as a subsidy. These agreements do not encompass other measures that simply have similar effects.[53]

The only possible option multilaterally for the US would be to introduce

[48] An interesting account of this process can be found in Levy (2011b).
[49] Reuters (2009).
[50] Levy (2010).
[51] A more in depth response can be found in Daily (2011).
[52] (Waibel, 2010, pp. 135).
[53] Waibel (2010).

new international agreements banning currency manipulation. In terms of international trade it could be argued that it is mutually beneficial for the world economy when the current account surplus or deficit of every nation is kept within a certain factor of their GDP.[54] While the US has tried to influence the G20 by having them include the word 'balanced' in a central statement about the global economy further efforts have not been fruitful. However had this been a high priority for the US, it seems likely that they could have exerted diplomatic pressure on other nations to commit to a clear defined policy by for example making it easier for foreign nationals to invest on the US market, or threatening to make it more difficult if other countries were unwilling to sign.

The consequence of such a treaty if it were strictly worded would be that participating countries could face penalties in case they were running a budget deficit or trade balance surplus. This is a huge dent in the right of most countries to autonomously decide on their monetary policy. Surplus countries such as Japan and Germany would probably oppose. And given the reluctance of the USA to give up autonomy in favor of multilateral organizations it is not clear that such a treaty would even be in the interest of the USA.

While these scenarios might not encompass all possible avenues of US diplomacy, they do illustrate how the most obvious multilateral options probably are not beneficial for the USA.

4.3 Persuasion

There migth still be an option for US officials to discuss Chinese monetary policy outside of formal diplomatic relations or international bodies. Critics of China sometimes supplement their case with the assertion, that a higher-valued RMB would actually be in the interest of the Chinese people, if not its export sector.

For an ordinary Chinese factory worker, the cheap RMB might on one hand mean that their factory is doing great on foreign markets, but at the same time buying foreign products like European cars or American gadgets becomes very expensive.

Additionally the artificially low interest rates, in combination with inflation, deprive Chinese citizens of attractive saving options on their bank accounts. Due to capital controls they cannot place their money in foreign banks where interest rates are higher. In absence of a comprehensive social welfare state,

[54] This argument is put forward for example by **?**.

retirement provisions become a major concern for many citizens.
Lacking other saving opportunities, many Chinese invest their money in real estate as a saving asset, driving real estate prices up. This confronts less affluent citizens with serious difficulties when they are looking for habitation in urban areas. Infamously high housing prices, e.g. in Shanghai, have become a major social issue, also reflected in popular culture.
One interesting example of an important public figure arguing along these lines is the head of the US Federal Reserve, Ben Bernanke. With his theory of the 'savings glut' he has been trying to persuade China that their economic policies are not only hurting the international markets but also turns out to have a negative effect on most Chinese citizens.
In a speech at the Chinese Academy of Social Sciences in Beijing he argued that: '*Greater scope for market forces to determine the value of the RMB would also reduce an important distortion in the Chinese economy, namely, the effective distortion that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market'*.[55]
In line with his 'savings glut' theory, Bernanke went on to point out that one of the most effective ways to increase the welfare of Chinese households would be to reduce the domestic savings rate. This argument plays nicely together with a line of reasoning he presents at a lecture in Virginia a year earlier, which shows a significant shift away from the manufacturing driven argumentation.[56] In this speech the main argument centers around how the 'savings glut' distorts international economy. As the Chinese store their wealth in banks instead of spending it in the domestic market, it gets reinvested for a big part in international projects, and particularly the US is a big receiver of foreign investment, which in turn creates a current account deficit. The main point of this argument is the idea that the current account deficit or surplus is largely driven by the international economic environment and as such is not solely a domestic issue. Following this line of reason, it is not solely the responsibility of the US to eliminate their deficit with budget cuts, but equally the responsibility of large international players like to China to take measures to assure a balanced world economic. In the particular case of China this could be done for example by strengthening their currency.
However while this argumentation was directed at China, there is no indi-

[55]The transcribed speech Bernanke (2006) used the term 'subsidy' which created a lot of debate in the US, but the word was never uttered by Bernanke himself while giving the actual speechReuters (2006).
[56]Bernanke (2005).

cation that it changed any policies. It is unlikely that Chinese economists had not been already aware of at least some of the points that Bernanke proposed. And more importantly, even if Bernanke's analysis was persuasive, there would be very little political will to take advice from the USA and take action as a reaction to perceived US pressure.

5 Conclusion

When we Look at the economic case against China, the evidence that the RMB has indeed been kept undervalued is overwhelming. Chinese monetary policy has been adjusting every lever suited to keep their currency at a low value. In addition, even though economic measures trying to estimate the deviation from the equilibrium exchange rate vary, they almost all find that the Chinese RMB in fact is undervalued.

We think that many attempts to point out other factors that also had helped to boost the Chinese export miracle over the last decade are justified in their assessment. These factors might help explain the success of Chinese exports in recent years. However, they do not rule out that *in addition* China has been keeping the RMB undervalued.

Providing a definitive proof that China has been engaged in such a behaviour is near impossible. For every part of China's monetary policy one can find good reasons, so it is difficult to point a finger at a specific measure. However, when looking at the exchange rate policy China has been conducting over the last decade as a whole we don't know how one could have a more clear case of an attempt to undervalue a currency.

And yet we find the political debate in the USA to be hyperbolic. When US politicians eagerly point their fingers at a supposed wrongdoing they ignore the fact that China is not doing anything wrong, i.e. they are not violating any legal framework. Every country is using monetary policy to satisfy its domestic goals so unless China has signed a treaty wowing not to undervalue its currency, it cannot be penalized in doing so.

We have discussed how some economists argue that China by joining the WTO has indeed signed a treaty that disallows them from pursuing an undervaluation of the RMB. This is also the argument made by Romney during the presidential election in 2012. If this were indeed the case then the US would be within their right to pursue China legally within the WTO. The fact that the USA has not attempted to use WTO to stop China from undervaluing its currency is a strong indicator that the illegitimacy of China's monetary policy is not that obvious. The hyperbole in the USA might partly stem from the fact that the USA have very little diplomatic leverage to influence Chinese monetary policy. As our discussion has shown, no promising unilateral nor multilateral diplomatic option within existing legal frameworks is available.

The accusation that China is violating not a legal but a *moral* framework of economic fairness is a different case. It might be honestly put forward by US labor unions, but as a political argument it would only be credible if the same US politicians would push for a multilateral treaty banning such behaviour. If US policymakers find China's policies to be harmful to such a degree that international action should be taken then we would argue that the only promising way forward would be to seek new multilateral agreements banning monetary policy that penalizes currency manipulation. Such efforts have not been followed seriously by US foreign policy however, probably because the USA themselves fear to loose the ability to decide their own monetary policy autonomously.

Moreover, China is taking other measures that benefit its export sector, such as the tax rebates, energy subsidies and — ironically for a 'communist' country — the suppression of effective worker organization in independent labor unions. On these issues US foreign policy has been much less vocal.

As long as no multilateral efforts for new international legal frameworks are taken, the domestic political debate in the US centers around an idea of economic fairness that does not have have any application in international economics. As such it does not serve as anything else than a rhetoric tool.

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