

Speaking truth to power: The use of economic arguments in the political debate about RMB undervaluation

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1 Introduction

In the presidential election 2012 the Republican candidate Mitt Romney made a tough stance against the currency policy of the People's Bank of China: In the presidential debate on foreign policy of October 23, he declared that 'on day one in office, I will declare China a currency manipulator'.¹ Already in 2008, then presidential candidate Barack Obama made a similar pledge.²

The Chinese reply on a equally high level. Premier Wen Jiabao

How comes a seemingly technocratic and complicated issue like China's currency policy plays such an important role in US politics? And, given its actual economic importance and the United States' possibilities to influence it, does the Chinese currency policy deserve such a central position in the United States' foreign policy debate?

In the first Chapter, we will look at the economics of the issue. Why could a undervalued currency be important? 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 focus on standard, textbook economic models and academic debates among economists about China's currency policy.

In the next Chapter, 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 this chapter, officials' statements and press releases are the main source of analysis.

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

In the final chapter 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.

What makes Chinese goods competitive on the world market? One might be tempted to point out the hard work, innovation and creativity of the Chinese working force.³ Not being convinced by this, economists have brought forward several other, more structural explanations:

¹<http://www.guardian.co.uk/world/video/2012/oct/23/debate-obama-romney-china-video>

²?

³As [?, p. 18] indirectly does.

One factor is *labor arbitrage*:⁴ 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.

Additionally Chinese producers rely cheap energy and land rents.⁵ 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, they maintain energy and land use prices that are cheaper on average than in industrial countries as well as other emerging economies.

An alternative explanation that has been proposed, especially by politicians and economists in the US, is that China conducts an *exchange rate policy* which makes Chinese goods more competitive. Their argument is that China is maintaining the Renminbi (RMB) at an artificially low value making it cheaper for foreign nations to buy Chinese goods and more expensive for the Chinese to buy foreign goods. During the last decade it has been commonplace to hear American politicians argue the unfairness of this practice, creating a heated diplomatic debate between these two countries.

In this article we intend to explore this issue by looking at it from different angles. To understand the mechanics of China's policies and the tools that we can use to judge the fairness of them, we look at the discussion as it has taken place in academic literature. Armed with this knowledge we turn to the politicians and look at how they present their arguments and for what reasons. Finally we aim to look at the academic and diplomatic debate in order to answer two questions:

- How does the political debate relate to the underlying economic principles and what explains the differences in viewpoints?
- With what right can the United States expect China to change their economic policy based on their argumentation?

⁴This 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.

⁵[?, pp. 25].

2 The economist' viewpoint

The exchange rate between two currencies is set based on how much it costs to buy a fixed amount of one currency with the other. This price depends on a vast array of factors and can be influenced both by the two governments as well as by market forces.

Macroeconomic theory postulates, that for every two currencies at every moment, there exists a balanced exchange rate, called the *equilibrium exchange rate*.⁶ If a currency is below this hypothetical rate, it is undervalued. If it is above it, it is overvalued.

If the market for currencies was completely competitive with firms, banks and private persons being able to buy and produce money at will, all exchange rates would always be at their equilibrium rate. However the production of money for a given country is controlled by their national bank. A national bank can - figuratively speaking - print a discretionary amount of money in their own currency.⁷ The way a national bank prints money is decided by a monetary policy.

2.1 Exchange rate 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 and the exchange rate of the Swiss franc. 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 exchange rate policy: Instead of focusing on inflation, the goal of the policy is to control the exchange rate.

Since manipulating the exchange rate can be beneficial for a nation's exports and foreign investments, National Banks often feel tempted to promote their

⁶[?, p. ?]

⁷The process is somewhat more complicated than printing bank notes, but the effect is the same for the purposes of this section.

country's exports by holding the exchange rate low. 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, 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 Monetary Fond), the WTO (World Trade Organization) and the EU (European Union).

2.2 The case against China's exchange rate policy

In the last decade China has been accused again and again by prominent US politicians of 'manipulating' its currency and keeping the Chinese currency, the Renminbi⁸ 'undervalued'. This accusation against China can be restated in terms introduced in the previous sections: It claims that China is using monetary policy to keep a fixed exchange rate *below* the equilibrium rate.

2.2.1 Deviation from the equilibrium exchange rate

There is a number of various different theoretical methods for estimating an equilibrium exchange rate in the literature that we broadly group in two approaches:

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

The basic idea of PPP approaches is to declare the exchange rate as ideal, at which you could buy exactly the same goods in two countries. A famous example of such an approach is The Economist's Big Mac Index.⁹ 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 sophisticated basket of goods than a Big Mac.

A problem of PPP approaches is, that the price level in emerging economies is generally lower than in advanced economies. According to the so called

⁸abbreviated to CNY. The basic unit of the Renminbi is the Yuan.

⁹<http://www.economist.com/markets/Bigmac/Index.cfm>

Balassa-Samuelson effect, this is mainly because services and non-tradeable goods (e.g. a haircut or a restaurant meal) are much cheaper in emerging economies.¹⁰ There are attempts to take account of such effects and calculate a revised PPP equilibrium exchange rate, with mixed results: Depending on the detailed assumptions, such attempts result in a wide range from the RMB being *overvalued* to a *undervaluation* of 47%.¹¹ Some attempts reach no statistically significant results.¹² Since most such calculations show a undervaluation of the RMB, some economists conclude the RMB must be undervalued, and they then estimate the degree of undervaluation to an average of the different approaches.¹³

However, to understand them it's necessary to introduce the notion net foreign asset as well as the concepts of current account and foreign account¹⁴. The net foreign asset is the value of the assets that a country owns minus the value of assets from that country which is owned abroad. Assets in this sense is usually state bonds but can also be stocks and goods.

The current and financial account are measures for how the net foreign asset changes. The current account constitutes the balance of trade and money transfers while the financial account constitutes the balance of financial assets, that is the money borrowed from abroad or the amount of money lent to other countries.

The two accounts are related by the current account plus the financial account being equal to zero. This makes sense intuitively since if a nation buys more goods than it can finance with exports it needs to finance this by borrowing money abroad instead. In this case, the negative trade balance translates to a current account deficit, while the influx of money coming from borrowing money translates to a financial account surplus.

When it comes to estimating the equilibrium exchange rate these three measures are heavily used because they give us an idea of how stable an economy is, judging from how assets and goods are flowing in and out of the economy. In particular a report was released in 2008 by the International Monetary Fund outlining three methods that can be used to estimate the disparity between the real and equilibrated exchange rate¹⁵:

1. The *macroeconomic balance approach* looks at projections of a country's current account and tries to estimate how much the exchange

¹⁰[?, pp. 82].

¹¹[?, pp. 72].

¹²[?, p. 83].

¹³

¹⁴For a more in depth explanation ?KrugmanTextbook provides a good introduction

¹⁵The Report: ?Lee08

rate would need to be adjusted for it to stabilize within a certain level

2. The *reduced-form equilibrium real exchange rate approach* tries to estimate the equilibrium directly as a function of the net foreign asset as well as a number of trade indicators
3. The *external sustainability approach* tries to find the exchange rate that would stabilize the net foreign asset of a country to within a certain level

In practice these techniques have been used by Cline and Williamson in their yearly policy brief on equilibrium exchange rates¹⁶. 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 tries to calculate how much the exchange rate would have to change to bring the current account within a normal threshold. In 2009 their results showed that the Chinese RMB was undervalued by 21.4%, a number which has been much quoted since then. Especially in relation to the fact that they found the US dollar 17.4% percent overvalued, further contrasting the value gap between the two currencies.

Instead of trying to find the equilibrium exchange rate, a different approach is to do the exact opposite. If we pick a comparative point in time or statistical measures based on other countries, we can measure how much the current exchange rate deviates from a factor that remains constant.

If we pick the unit price of labour as our constant and 1998 as our point of reference it is straightforward to show that the RMB is 25 percent undervalued when compared to at least the American Dollar¹⁷.

2.2.2 Circumstantial evidence for RMB manipulation

Many examples of estimates of the equilibrium exchange rate exists in the literature and few of them agree. Critics of China's monetary policy therefore often supplement their model-based estimates with a more theory-based circumstantial case. The structure of this argument is to ask what a National Bank would do according to textbook economics if it were trying to manipulate its currency and then to point the similarities to what China is doing.

¹⁶??

¹⁷?

So how would a National Bank keep a rate below its equilibrium rate? According to textbook economics this can be done in three ways:¹⁸

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 decreases, 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.

According to Goldstein and Lardy¹⁹ this is exactly what the People's Bank of China has been doing for a decade:

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 have actually been negative for the most part since 2006. but first find data (World Bank?)
3. China imposes foreign exchange controls that prevent international investors or other governments to buy RMB.

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. If the Chinese government buys foreign currency paying with

¹⁸[?, pp. 514]

¹⁹[?, pp. 40]

RMB, it is increasing the amount of RMB in circulation in the economy.²⁰ According to standard economic models²¹ an increase in the money supply means that the currency has less value and prices go up, leading to inflation.²² 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.²³ 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.

China has indeed seen some inflation during the last ten years. But it has only been moderately higher than in other countries. In fact the real and the nominal exchange rate roughly moved in unison during the last ten years.²⁴ find data to display Critics of China attribute this to China's *sterilization* of the money inflow. Since 2003, China has prevented about 40% of the money inflows of entering the monetary base by raising reserve requirements of Chinese commercial banks.²⁵ data? Raising reserve requirements limits the amount of loans the commercial banks can issue, therefore 'extracting' money out of the economy. This in turn limits inflation and prevents the real value of the RMB to rise. If China wasn't manipulating the exchange rate, critics argue, China wouldn't have to sterilize the money inflow.

2.3 Replies in favor of China's exchange rate policy

Many economists are more sceptical if the RMB is indeed undervalued. We present first the arguments attacking the above-mentioned estimates of equilibrium exchange rates, followed by the arguments responding to the more circumstantial evidence for manipulation of the RMB.

2.3.1 Difficulties in estimating the equilibrium exchange rate

The equilibrium exchange rate is an elusive concept. The above-mentioned calculations have been heavily criticized.

²⁰In economical jargon it is expanding the *monetary base*, what (other things equal) leads to an increase in money supply

²¹[?, pp. ?]

²²Maybe quickly explain the assumed mechanism?

²³[?, p. 509]

²⁴source: <http://www.clevelandfed.org/research/trends/2010/1110/01intmar.cfm>

²⁵IMF, via Cleveland Fed, <http://www.clevelandfed.org/research/trends/2010/1110/01intmar.cfm>

The approaches based on purchasing power parity (PPP) are considered problematic, because they yield such different results.²⁶ The result depends heavily the method chosen and its assumptions, too much so as to serve as a guide for exchange rate policy.

Approaches based on macroeconomic balance ideals also face problems:

2.3.2 Circumstantial evidence against RMB manipulation

The reply to the more circumstantial case against China's policy is at the same time more difficult and easier to make than the case against estimations of the equilibrium exchange rate. It is difficult because the case is based on textbook macroeconomic reasoning and nobody disputes that the People's Bank of China is actually taking measures suited to lower the price of the RMB: The accumulated Dollar reserves, low interest rates and capital controls cannot be questioned.

But the reply is also easier because the case against China itself is not completely clear and the alleged undervaluation of the RMB is not quantified. It is based on many 'judgement calls' and as such it is vulnerable.²⁷

In addition there are equally circumstantial cases to make against a alleged RMB undervaluation. First, as pointed out in the first section of this chapter, China's export success can be explained with a variety of factors. Different authors point to different reasons: Huang Yiping focuses on factor cost distortions.²⁸ Charles Wyplosz's and Helmut Reisen's focus is on the high saving rate in China.²⁹ What they 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.

Second, one might point out the symmetry of the world market.³⁰ While China is running a current account surplus, the US in turn run a current account deficit. According to Wyplosz, this deficit is caused by the low saving rate of US households and the budget deficit of the US government. 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 *overvaluation* of the US Dollar.

Third, each of the practices taken by the POBC may also have legitimate purposes. China is no the only country that pegs its currency to another

²⁶[?, p. 16] and [?, pp. 82]

²⁷[?, p. 85]

²⁸Huang2010, <http://www.voxeu.org/article/china-us-and-renminbi-rejoinder-krugman>

²⁹[?, pp. 40] and ?Reisen2010

³⁰[?, pp. 39-40].

currency - we already mentioned Switzerland and Denmark doing so. A fixed exchange rate has the advantage of giving firms and consumers certainty about the future value of a currency.³¹ Lowering interest rates to spur growth is also a tool widely used by National Banks worldwide. And limiting inflation is considered to be one of the main goals of *any* National Bank.³² Finally, many other countries - among them Japan, Germany and Switzerland - run current account surpluses that are as big as China's, relative to their GDP.

2.3.3 it is over

The last point to make against the accusations against China is extremely straight-forward: Even if the RMB was undervalued in the past, it is not so any more. Even some of the most ardent critics of China's exchange rate policy now reach this conclusion.³³

2.4 Wrap up: Up to 15% or more

3 The political debate

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. The Argumentation: What is the specific reasoning brought forth in the economic debate?
2. The Channels of Communication: Where does the debate take place and with what authority?
3. The response: What is the reaction to the debate from China's side?

³¹[?, p. 515]

³²China's capital controls might be the only exception, but their importance pales against that of China's foreign exchange reserves.

³³<http://krugman.blogs.nytimes.com/2012/10/22/an-issue-whose-time-has-passed/> and ?

4. The Context: Under what political or economic circumstances is the debate brought forth?

3.1 History of the political debate in the US

The following graph depicts the movement of the RMB real exchange rate against the US Dollar:

The RMB was pegged to the Dollar from 1994 at a rate of 8.28 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, the history of the political debate about RMB undervaluation can roughly be seen in four phases, following the movement of the USD-RMB exchange rate:

The debate in the US 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.³⁴ 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.³⁵

Speaking of currency *manipulation* and an *unfair* competitive advantage, the AFL-CIO Director makes clear that she does not consider China's ex-

³⁴[?, pp. 14]

³⁵AFL-CIO on U.S.-China Ties: Reassessing the Economic Relationship, <http://www.dossiertibet.it/news/afl-cio-us-china-ties-reassessing-economic-relationship>

change rate policy as purely technical but as an issue where political action 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. For example, 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?'. 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 in holding US inflation low.

In 2005 the *saving glut hypothesis* brought forward by Ben Bernanke opened a new line of criticism on China's export surplus.³⁶ 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 prosperity, and since the RMB had started to appreciate against the US Dollar anyway, the critique was not initially drawn into political spotlight.³⁷

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. 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 prominent are of course the presidential candidates and Barack Obama in 2008? and Mitt Romney in 2012? both made a tough stance against China's currency policy part of their agenda, wit both candi-

³⁶as explained in section ...

³⁷says [?, p.16].

dates following a remarkably similar argumentation, basing their argument on the trade ramifications of a purportedly undervalued RMB. Interestingly, Obama made the above-mentioned statement during a speech to the ‘Alliance of American Manufacturing’, an interest organization representing a part of the US manufacturing industry. Seemingly, after being joined by monetary policy officials and economists, the labor unions still remain at the core of the critics of China’s exchange rate policy.

The debate in the US reached a climax in 2009 up to the spring of 2010. The Obama administration, as well as policy experts worldwide were discussing the options for US political action against China’s exchange rate policy.

3.2 The political debate in China

Governor of the People’s Bank of China, Zhou Xiaochuan, among other PBC officials, is worried about excessive foreign exchange reserves:

4 Diplomatic options of the US

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’ doesn’t 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.³⁸

A

³⁸OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (H.R. 3) SEC. 3004. INTERNATIONAL NEGOTIATIONS ON EXCHANGE RATE AND ECONOMIC POLICIES., <http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/authorizing-statute.pdf>

In 2009 a bill was proposed by the republican senator Timothy Ryan (Ohio), aiming to introduce a tariff with the stated purpose “*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*”³⁹. The bill died in the senate after passing the house.

4.2 To argue convincingly

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, 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. 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*”³⁹. Given to a Chinese audience, Bernanke attempted to make the point that Chinese consumers would benefit from a stronger RMB as it would give them access to cheaper imports and strengthen Chinese companies on the domestic market. With this rhetoric he mirrors the politicians focusing on the currency value as a driver of product prices.

³⁹The transcribed speech³⁹ 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 speech³⁹.

However, in the same Speech Bernanke points 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 argumentation⁴⁰. In this speech the main argument centers around how the savings rate of Chinese citizens distorts international economy. Here Bernanke argues that the poor welfare offered by the Chinese state forces a most Chinese to set aside a lot of money for retirement and medical self insurance. As the money is deposited in bank accounts, it gets reinvested in domestic and international projects, and particularly the US is a big receiver of foreign investment, which 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.

These speeches were given at a point in time where China was giving up their peg of the RMB to the Dollar, slowly increasing the value over a 4 year period between 2006 and 2010.

4.3 Multilateral action

In the world of international finance there are several agencies responsible for coordinating various aspects of the world economy. A big part of the role of these organizations is to offer an avenue to settle disputes between member nations.

The three most relevant of these organizations in this context is the G20, the International Monetary Fund (IMF) and the World Trade Organization (WTO).

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 US several attempts at making the participating leaders pledge their allegiance to economic policies that would prevent countries from manipulating their currencies. However the strongest statement so far was reached at the 2009

⁴⁰The speech can be read found here ?

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 failed⁴¹.

An alternative approach would be to go through the IMF which stated goal is to stabilize exchange rates and lend money to countries that might need them. In fact Dominic Strauss Kahn has on behalf of the IMF publicly stated that the RMB is undervalued in 2009, and the IMF has repeated this sentiment with slight modifications since then⁴². Despite these statements no action has been taken by IMF to regulate or penalize China, largely because the organization lacks the means to influence countries that aren’t dependent on it for borrowing money.

Last the World Trade Organization is deliberately set up to supervise and liberalize international trade. In ? several chapters are devoted to an extended discussion about the interpretation of the ruleset laid out by WTO to ensure free trade. The central question being whether there are provisions in WTO agreements that can be used to prosecute China. However as discussed in ? the WTO is unable to cope with such a situation even if there were an article clearly stating that China was being guilty of economic misconduct.

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*”⁴², arguing that the conclusions made by the IMF are meaningless.

5 Discussion

Seeing that one decade of intense discussion hasn’t answered the question of whether China should appreciate their currency, so it might be a little ambitious to aim for a definitive conclusion on this matter. Instead, what we set out to do in the following part is two-fold. We will first try to look at how the viewpoints from the two sides of the academic debate diverges. Secondly we will assess the political debate looking at the motivations to argue one way or another.

⁴¹An interesting account of this process can be found in ?

⁴²A more in depth response can be found in ?

5.1 Academic Tug of War

At the center stage of the Academic debate we see the discussion surrounding the equilibrium exchange rate. Every single way we choose to measure this rate shows us that the RMB is severely under appreciated creating a strong argument in favor of appreciation. Supporting this idea we have Goldstein and Lardy enumerating how the Chinese state is guilty of doing everything you would expect a currency manipulator to do.

However, the response in defense of China's economic policies points out that this critique completely misses the point. Their argument is shortly summarized in two parts: 1) The monetary policy of China is a reasonable response in light of the economic circumstances and 2) Historically other nations such as Vietnam and Japan has been pressured into appreciating their currency with negative consequences to follow.

Economically speaking this highlights a clash of economic cultures. On the one side we see an economics tradition based on complex modelling and theoretical frameworks to understand the world. The idea driving this work is that we can deduce economic policies based on a deep understanding of the key factors that play a role in macro economics, i.e. by estimating a theoretical property such as the equilibrium exchange rate, we can deduce the policy that should be implemented.

The other side of the debate is represented in a larger degree by a practical and empirical method. Here the theoretical argument is discarded because it is too vague and imprecise. Instead the policy is based on using a set of practical tools (sterilization, foreign currency accumulation, etc.) used to obtain growth and prosperity. From this angle it is much more important to look at past experiences from other countries and learn practical lessons from their mistakes and successes, than it is to adhere to a theoretical model of how the perfect economic policy would look like.

5.2 Motivations

While the theoretical approach can easily look far fetched and out of touch with reality, the danger of the practical approach is that it might miss the big picture and end up shortsightedly driving the world economy towards a sub optimal economic environment. After all, a well-functioning domestic economic policy might easily work at the expense of neighboring nations, like the classical "beggar thy neighbor" situations introduced earlier. No man is an island, and similarly no economy stands alone in a global market. The question that lingers is to what extent a nation should be limited in

it's internal affairs to the benefit of other countries.

Historically China has been a small player on the world market for most of the past century despite its population size. Being a small player comes with the advantage that your economic policies affect other countries in a very minor degree which permits a wide liberty in setting them. China's economy can by no means be called small anymore, but the attitude put forth in their economic policies still mirrors those of a China that would best like to be left to do as they wish with regards to their own internal affairs.

The US on the other hand has historically been promoting free trade with the rest of the world, using IMF and WTO as instruments to open up the global market partly to their own advantage. Economically speaking the US has a history of meddling in the affairs of other countries convincing for example Japan and Vietnam to appreciate their currencies when it was seen as economically beneficial for the US that they do so.

These extremes set the stage for negotiations where any argument made by the opponent side can easily be distorted to reflect the more extreme part of their position. If the US tries to find common ground on currency speculation they can quickly be labeled as imperialistic, while any attempt China makes to retain control over their economic development could be categorized as protectionist.

5.2.1 Manufacturing Jobs

In his article "Assessing China's Exchange Rate Regime", Jeffrey Frankel and Shang-Jin Wei⁴³ starts by looking at the yearly US Treasury Reports. They found that the whether China would be labeled as a currency manipulator correlated not just with the current account ration as expected but also with metrics that aren't usually deemed to have an effect on China's currency policy such as the trade balance or the unemployment rate on election years.

There is no doubt that China to a certain extend serves as a scapegoat when manufacturing jobs are disappearing, and not without right. Manufacturing jobs are to a large extend being moved away from industrialized countries, often because of circumstances similar to those that the company Fluttr faced in our fictional example. It is however nonsense to expect that raised exchange rates is enough to stop this trend. If jobs aren't going to China, there are countries like Malaysia, Indonesia and India ready to step in, and

⁴³?

if the RMB strengthens, those countries are where the jobs will go, and not the US.

With this in mind it's clear that presidential candidates like Obama in 2008 and Romney in 2012 are merely paying lip service to the large share of dissatisfied voter groups that they hope will help them win the election. In US domestic policy China is an easy target because invoking the Chinese problem evades looking at domestic causes for the same problems.

This doesn't mean however that China couldn't potentially gain from strengthening the RMB. When Bernanke argues that raising the value of the RMB could be a win/win, he is not necessarily merely protecting national interests by perpetrating the myth of the disgruntled manufacturing industry. As we mention earlier, China needs to take strong measures to prevent inflation on their domestic market. On top of that the cheap RMB makes it difficult for Chinese people to buy products abroad, limiting their experienced prosperity in spite of the staggering growth rates.

5.2.2 Responsibilities

Academics are free to poke at China with a stick arguing that the RMB is under valued according to this or that model, and American politicians and manufacturers can complain about the job losses that China's policy is leading to. However they won't get results unless either Chinese policy makers decide that it is in their best interest to appreciate the RMB or an international organization is able to pressure China into doing it anyway. Outside of a modest appreciation between 2006 and 2010 neither happened despite consistent pressure from the US. Depending on your viewpoint this end result can be seen either as a confirmation that China never had an obligation to react, or that China neglected to step up to their responsibilities as a major economic power.

The idea of a savings glut introduced by the chair of the US Fed Ben Bernanke gives a strong argument for the latter by demonstrating how Chinese policies create a situation where enormous amounts of liquidity is created by the Chinese savings rate which gives an imbalanced investment abroad which to a certain extent explains both the current account deficits of the states and part of the current account surplus experienced by China. Because this savings rate is tied up to domestic economic policies in China but has global consequences, it would be frivolous to let China get away with manipulating it in ways that hurt other economies.

China is naturally not interested in giving up this kind of autonomy, and so far they have not seen any initiative that could challenge them to that right.

In the current situation it is hard to judge if they are taking unfair advantage of a broken system, or if they have every right to remain sceptic of foreign attempts at influencing their policies. However what the conflict shows very clearly is that had it been the case that China had been wrongfully taking advantage of their position as a major economic player, there would have been no system currently in place that would have been able to stop that from happening, outside of a full blown tariff war with the US.

In a future scenario it is likely that China will stand at the other side of the argument losing manufacturing jobs to poorer nations like Indonesia or India and arguing that these countries in turn are undervaluating their currency. When that time comes, it will hopefully be a little clearer when exactly this kind of policies is actually hurtful to the world economy, and not just an opportunity for poorer countries to get a foot in the door of mass manufacturing.