A study on why the United States must be cautious in attempts to accelerate appreciation of the RMB

By
Chazmon Q. Gates

A thesis submitted to the Johns Hopkins University in conformity with the requirements for the degree of Master in Government

Baltimore, Maryland
May, 2008

© Chazmon Q. Gates
All rights reserved
A STUDY ON WHY THE UNITED STATES MUST BE CAUTIOUS IN
ATTEMPTS TO ACCELERATE APPRECIATION OF THE RMB

ABSTRACT

China’s economy has grown exponentially, a level of growth unmatched by any modern economy. Millions of Chinese citizens have been lifted out of poverty as a result, and the standard of living for many Chinese has reached a new trajectory. In addition, with a growing middle class and increased money supply, real estate and other domestic industries are flourishing. Lastly, the U.S.-China bilateral trade reached some of its highest levels throughout the past decade, which has further integrated two economies that had little to no exchange just 30 years prior.

However, while China’s economy is benefiting from broad growth on many different levels, the U.S. is currently facing a grim economic outlook. Many economists and policymakers attribute an undervalued Chinese currency as the underpinning from which many of the economic concerns in the U.S. ranging from an unprecedented trade deficit to the unfolding of many domestic industries are possible. As a result, a variety of legislative remedies have been proposed in the U.S. Congress to recompense for the adverse effects that come as a direct result of China’s undervalued currency.

This thesis provides a thorough analysis of the policy proposals introduced in Congress as well as current policies of the Executive Branch. In doing so, the effects of similar aggressive policies currently being deliberated that were employed during the 1970s and 1980s to address the undervaluation of the Japanese yen will also be examined.

Given the significance that a growing Chinese economy has on the global market, in addition to the strong calls for reform in the U.S., this thesis advocates for careful policy measures that fall short of aggressive unilateral action taken by the U.S. In contrast to accelerating appreciation, this thesis argues that allowing a gradual increase could prove helpful in maintaining a stable Chinese economy and the long-term interest of the U.S. economy as over 1 billion Chinese consumers increasingly began to purchase American goods.
PREFACE

I want to extend special recognition and appreciation to my mother, family, friends, and mentors who never missed an opportunity to remind me that I can accomplish anything that I dream and work to attain. Your encouragement and support have served as the basis from which my hope and perpetual optimism for a brighter future originated.

In addition, I would like to thank Patrick Mulloy, Commissioner at the U.S.-China Economic and Security Review Commission for allowing me to interview you. Your input and broad knowledge on the U.S.-China bilateral economic relationship played an important role in helping me shape my final conclusions for this thesis.

To the Johns Hopkins University MA in Government program and more specifically, Dr. Kathy Hill, Dan Guttmann, and Brett Decker, thank you for introducing me to China and the greater Asian region. The first-rate education that I have received from this institution increased my potential to play a larger role within American government and subsequently, the global community.

Thanks to my education at Johns Hopkins University, I have grown a greater appreciation for American government and those who make such an institution possible.
A STUDY ON WHY THE UNITED STATES MUST BE CAUTIOUS IN ATTEMPTS TO ACCELERATE APPRECIATION OF THE RMB

TABLE OF CONTENTS

PAGES

1) INTRODUCTION................................................................. 1

1.1 Statement of the Problem ............................................ 2

1.3 Literature Review..................................................... 5

1.4 Thesis Outline.......................................................... 8

2) CHINA'S THREE STAGES OF CURRENCY REFORM.......... 11

2.1 Introduction............................................................. 11

2.2 Dual Exchange Rate Regime ........................................ 12

2.3 Unification and a Fixed Exchange Rate ......................... 17

2.4 Currency Basket Exchange Rate.................................. 25

2.5 Concluding Thoughts................................................ 30

3) IMPLICATIONS OF AN UNDervalued RMB...................... 32

3.1 Introduction............................................................. 32

3.2 Policy Implications for Trade .................................... 34

3.3 Policy Implications for China’s Holdings of U.S. Securities...... 40

3.4 Concluding Thoughts................................................ 43
4) CASE STUDY: IS THE U.S. REACTING TO A REAL THREAT...45
   4.1 Introduction..........................................................45
   4.2 Methodology..........................................................46
   4.3 Japan in Brief.......................................................51
   4.4 Is There a Pattern or Trend of a Threat.....................53
   4.5 Parallels for an Aggressive Response.........................66
   4.6 Examples of Implications from Japan.........................70
   4.6 Concluding Thoughts..............................................72

5) POLICY OPTIONS.......................................................75
   5.1 Introduction..........................................................75
   5.2 Legislative Branch..................................................77
   5.3 Executive Branch...................................................90
   5.4 Concluding Thoughts..............................................95

6) CONCLUSION...........................................................97

7) REFERENCES..........................................................104

8) APPENDIX.................................................................114
   3.1 States Affected by Trade Imbalance............................114
   4.1 Times Article 1986 and 2005 .....................................115
   5.1 Ryan-Hunter Dear Colleague H.R. 782.........................121
   5.2 Ryan-Hunter Dear Colleague H.R. 2942.......................123
LIST OF TABLES

Table 2.1 China’s Foreign Exchange Reserves and Overall Current Account between 1995 and 2004, before they implanted their currency basket regime. 24

Table 3.1 U.S. Merchandise Trade with China: 1980-2007 37

Table 3.2 U.S. Merchandise Trade Balances with Major Trading Partners: 2007 38

Table 4.1 A comparison between Japan and China’s growth during comparable periods of economic expansion. 56

Table 5.1 Import Statistics for Coated Free Sheet Paper from 2004 to 2006 92
LIST OF FIGURES

Figure 2.1 An illustration of a country's Balance of Payments Account, particularly displaying the difference between a country's Current and Capital Account. 49

Figure 2.2 An actual and hypothetical U.S. dollar exchange rate for the yuan between 2005 and 2007. 28

Figure 4.1 A breakdown of three perceived threats to the U.S. economy that Japan and China has in common. 55

Figure 4.2 The U.S. trade deficit in 1985. 58

Figure 4.3 The U.S. trade deficit in 2004 58

Figure 4.4 Japan's exchange rate movement between 1971 and 1979 66

Figure 4.5 Japan's exchange rate movement between 1984 and 1989 68

Table 5.1 Import Statistics for Coated Free Sheet Paper from 2004 to 2006 92
A STUDY ON WHY THE UNITED STATES MUST BE CAUTIOUS IN ATTEMPTS TO ACCELERATE APPRECIATION OF THE RMB

CHAPTER ONE

1.1 INTRODUCTION

Napoleon once stated that, “When China wakes, it will shake the world.”¹ Since Deng Xiaoping’s declaration of an “Open Door Policy” in 1979, the Chinese economy has experienced tremendous economic growth that has been unmatched by any modern country.² In addition, the way at which the country has sustained record growth over a relatively constant period is remarkable. This incredible growth has not only been beneficial for China, but also essential for the United States and numerous economies throughout the international community.

According to the U.S.-China Business Council, China’s real Gross Domestic Product (GDP) grew 10.7 percent in just 2006 alone.³ This level of economic expansion in one year equates to the aggregate growth many countries would amass over an entire decade. Also impressive is the fact that, less than a decade ago, China was the seventh largest economy before surpassing Italy, France, and the United Kingdom. Furthermore, when you consider purchasing-power parity (PPP) of this budding economy, by most measures, China is regarded as the second largest economy. Taking these facts into account, there should be no doubt that China’s economy is awakening, and as the world’s

---

² Deng Xiaoping was a prominent Chinese politician and reformer, and the late leader of the Communist Party of China (CCP). Deng never held office as the head of state or the head of government, but served as the de facto leader of the People's Republic of China from 1978 to the early 1990s.
³ See General and Financial Indicators of the People's Republic of China
fourth largest economy behind the United States, Japan, and Germany, China still has ample room for expansion.\footnote{See Walker, Marcus (2007) China’s GDP Poised to Top Germany’s as Power Shift Speeds Up}

In recent years, China’s thriving economy has also begun to produce an unprecedented number of middle class families.\footnote{See Faux, Jeff (2006) The Global Class War} As a result, the average Chinese today has some ten times the purchasing power they had just a quarter century ago. Many analysts believe that at this rate China could potentially reach the purchasing power of the U.S. in about two decades and surpass the economic superpower in about three decades.\footnote{See The Economist (2002) To Get Rich Is Glorious}

1.2 STATEMENT OF THE PROBLEM

While China is enjoying economic expansion, a growing middle class, and increased trade relations, the United States is simultaneously experiencing quite the opposite phenomenon. Moreover, the United States, through a robust bilateral economic exchange with China over the past decade, has experienced an unprecedented trade deficit, increased levels of unemployment, surging energy costs, and a middle class that appears to be shrinking due to widening disparities between the rich and poor. As a result, more and more lawmakers and policy analyst have become frustrated with economic policies that appear to give China an unfair advantage over the U.S., thus increased attention is now focused on the way at which China is regulating its currency.

Given that a significant deceleration of the Chinese economy is not expected in the near future, there are important currency valuation issues that should be addressed to ensure a more balanced U.S.-Sino relationship. Many policy makers believe that an
undervalued renminbi\(^7\) (RMB) is harmful to the U.S. economy and more specifically the running U.S. trade deficit with China.\(^8\) Indeed, increased trade with China plays a significant role in decreasing the cost for many goods sold throughout the United States, which simultaneously benefits both the American and Chinese economies. However, an extremely undervalued currency has augmented the steady and overwhelming flow of cheap goods from China and has made it difficult from U.S. companies to compete. It has also been argued that since an undervalued RMB equates to cheaper goods and services, this in turn directly affects the American worker by placing tremendous downward pressure on their wages. With that said, if China intends to become a trusted international player, it will need to revalue its currency and implement a more flexible exchange rate that is fair and reflective of market forces.

However, some economists do not agree that China's valuation is the problem behind many of the concerns facing the U.S. economy. In fact, there is concern that U.S. pressure to encourage China to appreciate the RMB could actually be detrimental to China's growing economy. In addition, there is concern that the impact of an ailing Chinese economy, as the result of a failed currency policy, could impact many economies throughout the international community. Thus, the stakes are too high for China and the U.S. to assert a currency policy that is overly ambitious and potentially too aggressive.

Therefore, it is important to know where China is headed with what some perceive to be its manipulative economic policies; what are the country's intentions; what could aggressive pressure from the West mean for US-Sino relations and could this lead

---

\(^7\) The renminbi is the currency of the mainland of the People's Republic of China whose principal unit is the yuan.

to an inevitable collision? The goal of the research involved in this thesis is to find answers to these important questions by providing the reader a historical analysis of the evolution of the RMB as well as an assessment of the currency regime China currently employs.

The scope of this study focuses on the current policy debate in Washington as it relates to China’s currency valuation and the approach that the U.S. should take with regards to addressing this issue. In addition, it is the intent of this thesis to dissect the dichotomy of views from the various interests groups and think tanks as well as the very different policy prescriptions proposed between the Executive and Legislative Branches of government.

This thesis topic comes at an important time as the international community becomes ever more integrated and the possibility for crisis is augmented. To this, as China continues to grow and develop into a dominant fixture within the international community, the U.S. will have to contend with this fact within its policy recommendations. In addition, given that China’s influence continues to grow, the stability of the global economy will become even more contingent on the economic policies that are implemented from Washington and Beijing. Hence, the topic of this thesis aims toward offering an understanding that a balanced and mutually beneficial economic relationship is essential for both countries and the global economy.

The principle argument of this thesis advocates for a balanced policy that maintain steady political pressure on China for its continued commitment to a gradual yet steady appreciation of the RMB. In addition, this thesis argues that the U.S. must push for a policy that will not only prevent the potential for instability but which assists
the continued growth of both economies. Lastly, this thesis finds that the range of policy proposals that have been introduced are all well intended and aim toward a common objective. However, policies that advocate for a hasty appreciation of the RMB through retaliatory measures can be excessive in nature and research throughout this thesis proves that they potentially run the risk of exacerbating the possibility for an economic crisis.

1.3 LITERATURE REVIEW

As speculation regarding the likely benefits or impairments, as it relates to China’s unprecedented growth, continue to increase, more and more analyst are beginning to provide important research into this phenomenon which is still evolving before our very eyes. In addition, Congress has become more aggressive in its approach toward establishing innovative policies aimed at reconciling the discrepancies that lawmakers perceive to be the cause for China’s surplus in contrast to a mounting U.S. deficit. This increase in interest has provided a plethora of prior research that provides a record of ideas and policy prescriptions, which were beneficial in guiding the assumptions and primary argument of this thesis.

In an effort to equally scrutinize the dichotomy of views towards U.S. economic policy with China, this thesis includes research from notable conservative and liberal think tanks alike. Think tanks of particular interest were those that contribute to the leading views, which permeate throughout our foreign policy such as the Rand Corporation, Center for American Progress, the Heritage Foundation, and the Brookings Institution. As a result of this particular focus, the stark differences between the more
labor focused and business opinions and philosophies as it relates to their proposed courses of action concerning China’s currency regulation became abundantly transparent.

The information and proposals provided by the think tanks who focused more on labor were more inclined to advocate for cautious interaction with China. They were in fact more likely to draw attention toward the gloomier side of U.S. involvement with China and never missed an opportunity to highlight the adverse effects created as a result of the relationship between the two countries. However, the investigative research that they provide makes significant contributions in analyzing indisputable problems that pose significant threats if China continues to allow the RMB to be undervalued. As a result, Center for China Currency Coalition and the Economic Policy Institute for example, tend to advocate for more protectionist measures concerning trade in addition to harsh punitive measures created in an effort to essentially force China to immediately revalue the RMB and enact a more free-floating currency.

Some economists such as Nicolas Lardy for example, appear to be uncompromising at times in their criticism toward China and its currency regime. However, they provide strong reasoning as to how serious the affects are to the U.S. concerning the undervaluation of the RMB. Yet, this thesis finds that their proposed courses of action lean more toward retribution instead of reconciliation. This could pose the risk of harming the Chinese economy, which is still developing, and some economists believe that the RMB may not be ready to float freely and manage the complexity of a free market. Indeed, China has shown that it is trying to make cautious reforms in an effort to head in the direction that the US would prefer, but hasty and premature moves could prove detrimental for this economy and U.S.-Sino relations. To

that end, this thesis found the more labor focused interest groups to be extremely helpful in providing a thorough assessment of the problems the U.S. faces with China’s slow embrace of full reform, but falls short of endorsing any particular policy.

In contrast, some of the more business-focused think tanks have a propensity to rely heavily on market forces as opposed to what they deem, drastic government intervention. They also tend to assert the need for a moderate approach that actually focuses less on China as the sole problem and more on the need to assist its economy as it gradually evolves. In fact, the idea that quick action on behalf of the U.S. could backfire, for example, is a leading theory that advocates for a more cautious approach toward dealing with China’s currency valuation. The research from these interest groups was extremely helpful in understanding the reasoning behind China’s resistance to hasty reform. It also provided balance to this thesis by highlighting the many benefits the economic relationship offers the U.S.

It is important to note however, that both the labor and business focused think tanks and interest groups recognize that there are challenges with regards to China’s currency regime. While they tend to differ in their demonstration of the severity of the challenges, both however, propose solutions that are essential in trying to create a balanced approach to deal with this issue.

In addition to think tanks, when you consider the policies of the Executive branch versus that of Congress you find that there are clear differences between the two branches of government. Many analysts have observed that whether there was a Democrat or Republican in the White House, there has been a difference in views

---

between the two branches. However, similar to the competing views of various think tanks, both branches have well intended solutions for a common problem. This thesis takes advantage of the abundant resources from government agencies such as the Congressional Research Service and the U.S.-China Economic and Security Review Commission, which provide detailed reports of U.S. interaction with China. This data is particularly important as it provides up-to-date analysis, which is critical to preserving the relevancy of the research provided in this thesis.

Lastly, it is important to note that this thesis includes economic statistics and data primarily based on information from the Chinese Government, which is known to misrepresent or misreport some of its economic data. This is a limitation faced by all researchers and analysts examining the Chinese economy. Although the reliability of the data is somewhat questionable, it is the best and sometimes the only economic information available for an analysis of this type. The Heritage Foundation Report, The 2008 Index of Economic Freedom, ranks China 126th out of 157 countries whose economies were assessed for economic freedoms. In addition, the Heritage Report ranked China 23rd out of the 30 countries in the Asian-Pacific Region. The lack of transparency this represents provides a level of difficulty with regard to gathering economic data upon which to base sound conclusions on China's economic progress. It also represents another problem that China must addresses as they strive to become a market economy. Nevertheless, the arguments and overall conclusions in this thesis are based on a compilation of research, records, data and an analysis that does not only rely on the figures provided by official Chinese government sources.

---

1.4 THESIS OUTLINE

China’s currency structure is complex and thus, fully comprehending the dynamics require the reader to understand how it evolved to its current form. Therefore, this thesis begins by providing the reader with a chronological account of the stages at which China’s currency regime has developed. The scope of this assessment focuses solely on the era of reform, which began in 1979, as this was the period when China initiated its first major currency reform after Deng Xiaoping’s economic reforms.

Upon garnering an understanding of China’s currency evolution, the reader will become familiar with the three major exchange rate reforms, the dual exchange rate, fixed or pegged exchange rate, and currency basket regime. As a result, the reader will also be able to understand the intricacies of the current system in place. Chapter two is particularly important because it establishes the foundational knowledge of China’s exchange rate policy, which will enable the reader to properly evaluate and judge the opinions and recommendations of critics and leading policy makers provided throughout this thesis.

Chapter three provides an assessment of the policy implications that China’s currency valuation present to the U.S. economy. This chapter includes an overview of the leading theories and assertions as to the exact effect, good and bad, that China’s economic policy has on the American economy, specifically jobs and the mounting trade deficit. As such, the reader could find this section to be subjective in nature as it displays views that are prominent within the liberal and conservative mainstream respectfully.

Chapter four includes a detailed case study that evaluates Japan’s similar experience with U.S. pressure to appreciate its currency during the 1970s and 1980s.
This includes a detailed historical evaluative of the major policies that were implemented in an effort to provide a remedy for the U.S.-Japan imbalances during that time. The effects of these policies on Japan's economy is also examined. Furthermore, this case study yields strong inferences from which it is possible to postulate the potential effects that premature and hasty appreciation may have on China's economy and long term development. The accumulation of research provided in this section is valuable and offers the reader an understanding of what options are plausible and what decisions could backfire according to history and prior attempts.

The remainder of this thesis focuses on the primary purpose of this research, which is to observe the policy options and opportunities that could provide the best way forward toward a balanced and mutually beneficial relationship between the U.S. and China. Accordingly, chapter five evaluates the positions and proposals from both the Legislative and Executive Branches of government. The reader will find in this chapter that there are a number of legislative remedies that have been introduced, yet due to various circumstances, have not become law. However, the emergence of such legislation indicates a problem, and the fact that many of the bills have not become law reveals that there is some reluctance to move forward. As such, chapter five attempts to provide an answer to this issue by also inquiring into the position of the Executive Branch and remedies that is currently at play. Upon doing so, the reader will soon understand that both branches have differing views regarding the best way to move forward with the growing concern of China's currency regulation thus, aggressive legislative prescriptions have been kept at bay.
This thesis closes by restating the intended proposal of a balanced policy that continues to take moderate measures to keep China moving toward a free-floating currency while also giving it the time necessary to maintain a stable economy. Upon concluding this research thesis, the reader should have a thorough understanding of China’s currency exchange regime in addition to a comprehensive view of plausible policy options that attempt to correct the imbalance between the U.S. and China.
CHINA'S THREE STAGES OF CURRENCY REFORM

CHAPTER TWO

2.1 INTRODUCTION

Throughout the close of the 20th Century and into the 21st, the Chinese economy experienced unprecedented levels of growth unmatched by any other developing economy at comparable stages of maturity. This substantial expansion of China’s economy has made possible enormous opportunities for justifiable outlays and investments that will further enhance economic prospects for continued growth.

Moreover, given that China’s 1.3 billion consumers is a gigantic portion of the global population, it is in the interest of the United States and the international community to see China prosper.

Following his historic visit to China in 1972, President Nixon and subsequent Presidents thereafter, all understood the significance of a strong Chinese economy and US-SINO relationship. In particular, the powerful influence of the two economies was expected to open new markets and expand prosperity beyond both countries borders. Fast-forward to over three and a half decades later and it is obvious that the stated assumptions have largely come to fruition. Despite substantial economic growth in addition to improved relations with the U.S., considerable increases in China’s foreign exchange reserves and a mounting trade surplus in contrast to that of a swelling US deficit has critics calling into question the way at which China regulates its currency.
Since 1980 following Deng Xiaoping’s initial declaration of an “Open Door Policy,” China’s currency exchange rate has undergone three major reforms that has changed the level at which the RMB is valued. The three stages of reform consisted of a dual exchange rate policy, fixed exchange rate or peg policy, and the current implementation of a currency basket policy. Each are similar in the fact that they all have drawn their fair share of criticism charging that the methodology which determines the value of the yuan is manipulative and inequitable. However, notwithstanding the fact that close scrutiny and criticism may be warranted, most critics should agree that China’s contemporary method of currency valuation has evolved into a more tolerable standard.

Chapter 2 provides a historical evaluative of the evolution of China’s exchange rate by focusing on its modern currency exchange rate policies and reforms that served as the antecedent to the current system it currently employs. The subsequent information should provide the reader a strong illustration of how far China has come since its initial phases of reform.

2.2 DUAL EXCHANGE RATE REGIME Dual

The utilization of a dual exchange rate is not uncommon in today’s modern economy however, this method of currency exchange is traditionally exercised by developing economies, many of which are in need of a particular safety net or cost effective structure that provides much needed economic relief. Particularly, China’s decision to convert to a dual exchange rate system was in anticipation of the adjustments that would ensue as a consequence of the free market reforms that were being implemented at the time by Leader Deng Xiaoping. Moreover, the complexity of the
market during this period necessitated an exchange rate regime that would facilitate China’s efforts to boost international trade and business.

Many countries, for the most part, maintain a unified currency valuation regime that consists of one official exchange rate. However, a number of developing or economically challenged countries prefer the dual exchange rate system because it allows them the flexibility necessary to modify their rates in a way that is more cost effective for their economy. In addition to flexibility, this system is unique in the fact that it enables a country to circumvent the unpredictability of the market by providing significant control over the risks and probability involved in such a volatile environment. Furthermore, the ability to manage risk substantially reduces the chances of economic shock, which could be devastating to many of the already fragile economies. Dual exchange rates are in fact, expected to give a country a slight edge in the free market as the system amalgamates the advantages that are accompanied with both a floating and fixed exchange rate regime.

However, some experts assert that the enactment of a dual exchange rate policy should be employed for transitional purposes only.\textsuperscript{13} Moreover, the system of a dual exchange rate was never regarded as an arrangement that should be permanent because it skews the actual value of goods and services. As such, economies that prolong their reliance on a dual exchange rate regime will presumably be regarded as a currency manipulator. As a result, the country would thus run the risk of retaliation from other nations such as the U.S. who may consider its actions ominous and inconsiderate of the economic viability of its trading partners. In fact, during the 1980’s the U.S. became so concerned about rampant currency manipulation that the Congress passed the 1988

\textsuperscript{13} See Xiaoqin-Fan, Emma. (2004) A Note on Dual/Multiple Exchange Rates. pg 8
Omnibus Trade and Competitiveness Act\textsuperscript{14} to prevent abuse of the dual exchange rate system and other manipulative currency regimes.\textsuperscript{15} This action by the U.S. Congress would later play a major role in influencing China to make additional reforms to its exchange rate.

The methodology behind a dual exchange rate system typically consists of a fixed exchange rate\textsuperscript{16} that is determined by the government or respective central bank in addition to an adjustable rate, which is determined by the market, albeit some countries such as China establish a variety of ways to determine the adjustable rate. This is accomplished when a different exchange rate is applied to the current\textsuperscript{17} or financial (capital) accounts\textsuperscript{18} of a country’s balance of payments\textsuperscript{19} (BOP).\textsuperscript{20} In contrast to a dual exchange rate system, most countries apply equivalent exchange rates to both accounts of the BOP. This provides a clear and unambiguous transaction that does not distort a countries international balance of payments.

\textsuperscript{14} The 1988 Omnibus Trade and Competitiveness Act requires the Treasury Department to determine whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining an unfair competitive advantage in international trade. If manipulation is found, the Department of Treasury is required to negotiate and end to such practices. It also requires the Department of Treasury to annually report on the exchange rate policies of foreign countries that have large global current account surpluses and large trade surpluses with the United States. (Morris, 2008)


\textsuperscript{16} A type of exchange rate policy where a currency's value is matched to the value of another single currency or to another measure of value, such as gold. As the reference, value rises and falls, so does the currency pegged to it.

\textsuperscript{17} The current account is the sum of sales from trade in goods and services, factor income such as dividends and interest payments from abroad, and transfers from abroad such as foreign aid, grants, gifts, etc.

\textsuperscript{18} The financial account records transactions that involve financial assets and liabilities and indicates the functional categories, sectors, and instruments used for international financing transactions.

\textsuperscript{19} Balance of payments measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year. The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers.

\textsuperscript{20} Fan Xiaojin-Fan, Emma. (2004) A Note on Dual/Multiple Exchange Rates. pg 1
The dual exchange rate regime proved to be a successful system for China’s reforming economy and the country therefore, continued this practice throughout the entire decade of the 1980s and into the 90s. What particularly made this exchange regime extremely attractive for China was its ability to devalue the cost of their exports. This made Chinese exports cheap and thus tremendously appealing to foreign countries who desired to maintain low prices for goods and services. As such, demand for Chinese products increased, further providing a desirable boost to the country’s economy.

Devaluation was achievable through an Internal Settlement Rate (ISR)\textsuperscript{21} which China established in 1980. The advent of the ISR subsequently reduced the value of the RMB by half with a settlement rate of 2.8 yuan to the dollar.\textsuperscript{22} The ISR satisfied the dual exchange rate by serving as the market rate that coexisted with an official rate of 1.5 yuan to the dollar. China’s trade corporations adhered to this rate to settle their foreign exchange earnings and payment with the government. During this period in the 1980’s, some analyst believed that the ISR played a significant role as it was presumed that the exchange rate for the yuan, for the first time, was somewhat reflective of the prices between China and its trade partners.\textsuperscript{23}

However, the United States and other trade partners with China began to scrutinize this practice on the basis that it provided an unfair advantage to Chinese trading companies. Many U.S. companies began to compare the benefits of the ISR to the equivalent of a government subsidy and charges of manipulation became prevalent.

\textsuperscript{21} The Internal Settlement Rate was an internal calculative used to determine the exchange rate for foreign exchange earnings/payment with the government. It was determined on the basis of the average cost of generating one U.S. dollar of foreign exchange earnings plus a 10 percent margin.
China soon began to explore alternative options that would enable the country to rule out the possibility of its practices being determined manipulative.\textsuperscript{24}

Under close consultation with the International Monetary Fund\textsuperscript{25}, albeit the IMF does not fully disclose its counsel given to foreign governments, we do know however, that China was advised to accelerate its capability to unify its exchange rate.\textsuperscript{26} This effort in addition to increasing pressure from the U.S. influenced China’s decision in 1986 to abolish the ISR. This action, to some extent, allowed the yuan to float freely for the first time because its Foreign Exchange Adjustment Centers (FEAC)/Swap Market determined the exchange rate from that point forward.\textsuperscript{27}

In the FEAC, exporters, importers, and other parties with foreign exchange could sell their foreign exchange holdings under a market-determined exchange rate that was based on the rates agreed on between buyers and sellers of entities authorized to retain foreign exchange earnings. While this was not your traditional foreign exchange market in comparison to the U.S., it played an integral role within an exchange market that was exclusively unique to China.

\textsuperscript{25} The International Monetary Fund is an international organization of 185 member countries. It was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.
\textsuperscript{27} In finance, a swap is a derivative in which two counterparties agree to exchange one stream of cash flows against another stream. The five generic types of swaps, in order of their quantitative importance, are: interest rate swaps, currency swaps, credit swaps, commodity swaps and equity swaps.
2.3 UNIFICATION AND A FIXED EXCHANGE RATE

Following China's elimination of the ISR, the RMB experienced major fluctuations in valuation leading into the 1990's. In 1986, Chinese authorities first reduced the value of the RMB down to a rate of 3.2 yuan to the dollar and again in July by 15 percent, which placed the RMB at a rate of 3.7 yuan to the dollar. The RMB remained relatively constant until 1989 when the value plunged 21.2 percent to a low rate of 7.2 yuan to the dollar.²⁸ By 1990 the value recouped to a rate of 5.22 yuan to the dollar.²⁹

During this period, China continued to operate under a dual exchange rate regime, although its practice under this system began to come under intense scrutiny from the U.S. who took steeper measures to declare China a currency manipulator. Beginning in 1992, under U.S. law with specific reference to the 1988 Omnibus Trade and Competitiveness Act, the U.S. Department of Treasure brought before Congress, charges of currency manipulation against China. According to the Department of Treasury’s semi-annual reports to Congress, since it began in 1988³⁰, China was reported on the list of, "Economies considered to have manipulated exchange rates," five times between 1992 and 1994. In each of those years, the Department made the following remarks to highlight China’s manipulation:³¹

²⁸ See Lardy, Nicolas (2005) Exchange Rate and Monetary Policy in China. pg 43
³⁰ In the October 1988, Korea and Taiwan were the only two countries who were reported. In the April 1989, Korea and Taiwan were once again the only two countries reported. In the October 1990, Taiwan was removed and Korea was the only country reported.
May 1992 Report:\textsuperscript{32}

- The size and growth of China’s external payments surpluses are a source of serious concern. These surpluses result in large part from pervasive administrative controls maintained by the Chinese authorities over the external sector of the economy, including a highly regulated system of foreign exchange allocation and direct controls on imports. At the same time, balance of payments adjustment in China has been hindered by continued devaluation of the administered exchange rate and controls on exchange rates in the nation’s foreign exchange swap centers.

... Given the size of China’s external payments surpluses and the level of its foreign exchange reserves, continued devaluation of the administered exchange rate and control of swap center rates must be viewed as an effort by the authorities to frustrate effective balance of payments adjustment.

December 1992 Report:\textsuperscript{33}

- The report also (aside from Taiwan) stated that China continued to manipulate its currency. It noted that, given the size of China’s external payments surpluses and the level of its foreign exchange reserves, continued use of the administered exchange rate and of regulated swap center rates must be viewed as an effort by the authorities to frustrate effective balance of payments adjustment.

May 1993 Report:\textsuperscript{34}

- The report noted that while China had committed itself to reform its trade regime, for example, in the context of the GATT\textsuperscript{35}, similar commitments had not been made with respect to its foreign exchange system. Chinese officials had expressed general support for reform of the system, and the long-term objectives of unifying the dual exchange rates and making the currency convertible. However, they had not indicated the specific nature of the steps they planned to take nor the timing of reform. While there was some prospect that China’s current account surplus might diminish in 1993, its foreign exchange restrictions continued to impede balance of payments adjustment and to contribute to large bilateral trade surpluses. In 1992 and early 1993, no significant changes were made in China’s foreign exchange regime, and the authorities continued to maintain limits on...

\textsuperscript{32} Taiwan was the only other country reported.

\textsuperscript{33} Taiwan was again the only other country reported.

\textsuperscript{34} China was the only country reported for the remainder of the reports to Congress. No other countries have been reported a currency manipulator since China’s final report in 1994.

\textsuperscript{35} GATT, The General Agreement on Tariffs and Trade was the outcome of the failure of negotiating governments to create the International Trade Organization (ITO). It is the precursor to the World Trade Organization, which China gained membership in 2002.
access to foreign exchange. Therefore, it was Treasury’s judgment that China was manipulating its foreign exchange system in a manner that prevents effective balance of payments adjustment within the meaning of the Act.

**November 1993 Report:**

- The report expressed support for China’s plans to move towards a more market-based economy and reform its foreign exchange system. It noted, nevertheless, that China’s foreign exchange system continued to be heavily regulated and the United States was seriously concerned with the level of China’s bilateral trade surplus with the United States. Based on China’s continued reliance on foreign exchange restrictions, Treasury considered that China continued to manipulate its exchange rate under the meaning of the Act. Treasury urged Chinese authorities to eliminate all restrictions on access to foreign exchange, a step which would facilitate imports and promoted adjustment in China’s large bilateral surplus with the United States.

**July 1994 Report:**

- Treasury welcomed China’s decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994, segmented the foreign exchange market and imposed restrictions that limited foreign-funded enterprises access to foreign exchange. Based on China’s continued reliance on foreign exchange restrictions that could limit imports, the report concluded that Treasury considered that China manipulated its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage.

As stated in the Treasury’s final report to Congress on China’s currency manipulation, in January of 1994, China officially unified its exchange rate. This represented the country’s second major currency reform since modern integration into the free market. However, while unification represented a major achievement, China’s currency still did not float freely, as was the intended goal of U.S. pressure for currency reform. In 1994, China essentially began to fix or, as this thesis will refer to it, peg the value of the yuan to the dollar. In doing so, as China’s economy would continue to
mature and subsequently acquire a substantial surplus, calls for further reform would return with even greater vigor.

Upon unification in 1994, Chinese authorities devalued the official exchange rate and integrated it with the prevailing market rate of 8.7 yuan to the dollar. In addition, they proceeded with a fixed exchange rate in which, the yuan was pegged to the U.S. dollar. The objective for pegging the yuan to the dollar was to produce the most comparable parallel to a floating exchange rate as possible, aggressive government intervention notwithstanding.

The methodology of a fixed exchanged rate is based off the aggregate demand of the currency being pegged and in this particular case; the prevailing currency is the dollar. As with a normal free-floating exchange rate, the relative demand for U.S. goods and assets would either increase or decrease the value of the dollar. Therefore, in the free market, the value of the dollar and other free-floating currencies fluctuate according to market forces that illustrate the relative demands of consumers, corporations, etc.

In the case of China’s peg to the dollar throughout the 1990’s, in order for the exchange rate to remain unchanged and maintain a rate of 8.7 yuan to the dollar, Chinese authorities would be required to tightly manage the BOP between China’s Current and Capital Accounts. The chart below is an illustration a country’s BOP.

---

36 See Lardy, Nicolas (2005) Exchange Rate and Monetary Policy in China. pg 43
International Balance of Payments

Current Account Balance  =  Capital Account Balance

\[ \text{[(Exports-Imports) + Net} = \text{[(Private Capital Outflow-Inflow)} + \text{Change in Foreign Exchange} \\
\text{Investment Income+ Net} + \text{Reserves}] \text{ Unilateral Transfers]} \]

Figure 2.1  Source: Congressional Research Service

Government intervention of great lengths on China’s behalf is required to maintain the same exchange rate. This is because it would require Chinese authorities to increase or decrease foreign reserves at the same rate at which net exports (imports) or net private capital inflows (outflows) increase or decrease.\(^{38}\) For example, if the value of the dollar were to decrease or increase relative to that of the yuan, Chinese authorities would then need to purchase or sell the level of U.S. currency necessary to retain the same exchange rate at a certain level. This can be done by purchasing foreign exchange reserves (Forex reserves), thus resulting in an increase in the Capital Account.\(^{39}\) Therefore, the peg essentially adjusts with the prevailing currency (U.S. dollar) as it fluctuates according to market forces. Taking into account the level of intervention required in this process, it does not take much effort to comprehend why many critics consider this practice manipulative.

It is appropriate at this point to include a historical evaluate of the fixed exchange rate in order to fully understand the problem that transpired from China’s use of this

---


\(^{39}\) Foreign Exchange Reserves are assets of a central bank held in different reserve currencies, such as the dollar, euro and yen, and used to back its liabilities and the various bank reserves deposited with the central bank, by the government or financial institutions.
system. In addition, it is important specifically for those who may argue that the U.S. has allowed countries to peg their currency to the dollar for years. Indeed, the U.S. has allowed pegs to the dollar and this process dates back to 1944 during the conference at Bretton Woods. This conference was the result of 44 nations coming together to repair the post World War II international economy.

Negotiations at the conference led to an agreement to establish the Gold Exchange Standard, which subsequently made all participating currencies convertible.\textsuperscript{40} However, the currencies were pegged to the U.S. dollar, which became the dominate international currency. Hence, the dollar was the only currency fixed to gold at $35 per ounce of gold. The Bretton Woods system was indisputably successful in assisting the European economies recover from their fiscal setbacks as a result of war.

However, some analysts dispute the fact that China properly utilized the fixed exchange rate as was originally designed to assist developing economies.\textsuperscript{41} In fact, they assert that the way at which China operated its fixed exchange rate was, compared to the practices of Bretton Woods participating economies, manipulative and placed the dollar at an unfair disadvantage.

The reasoning behind this argument is that the countries who participated in the Bretton Woods System, pegged their currency to the dollar at a fixed parity, which basically consisted of the rate of exchange between the currencies to the dollar. In doing so, the rate of exchange of the currencies was fixed at a rate plus or minus 1 percent of the rate of exchange to the dollar. This practice differs from the contemporary method used by China since officials did not have a set limit upon which they controlled.

\textsuperscript{40} Convertible means that the currency can be quickly and easily bought and sold for other currencies.
\textsuperscript{41} See Glick, Reuven and Spiegel, Mark (2005) The Bretton Woods System: Are We Experiencing a Revival? Symposium Summary
fluctuation against the dollar. Unlike prior regimes that had a set limit, what China did to control oscillation is sell the yuan for dollars.\(^{42}\) Consequently, the value of the yuan is reduced against the dollar whose value is thus increased. Accordingly, goods and services become cheaper and international demand for products from this country increases. This is where potential problems arise and pronouncements of manipulation and a proliferation of calls for reform occur.

As mentioned earlier, the fixed exchange rate was intended to be temporary and specifically designated to assist fragile economies. The problem arises when a country like China appears to no longer need this sort of transitional exchange rate regime and it subsequently begins to emerge, in the view of outside critics and economist, as an added benefit that gives inequitable advantages. The common prerequisite to initiate such criticism is to accumulate excessive amounts of foreign exchange reserves.

Again, given that China began to peg the yuan to the dollar in 1994, the country was required, in order to satisfy the methodology behind the peg policy, to purchase a certain amount of U.S. dollars to maintain a certain rate. However, if demand were to increase, China would therefore have to purchase comparable amounts of U.S. dollars which would increase its forex reserves and U.S. demand to comparable levels. That said, if demand for the yuan were to increase dramatically, China would thus experience dramatic increases in forex reserves. The chart below displays China’s forex reserves following its second reform in 1994 to the fixed exchange rate.\(^{43}\)

\(^{42}\) See Reuven, Glick & Aizenman (2005) Pegged Exchange Rate Regimes-A Trap
\(^{43}\) In 2005, China changed their fixed exchange rate regime hence; this chart does not include most recent data.
China's Foreign Exchange Reserves and Overall Current Account

**Surplus: 1995-2004**

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign Exchange Reserves - Capital Account</th>
<th>Current Account Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billions of $</td>
<td>% of GDP</td>
</tr>
<tr>
<td>1995</td>
<td>75.4</td>
<td>10.8</td>
</tr>
<tr>
<td>1996</td>
<td>107.0</td>
<td>13.1</td>
</tr>
<tr>
<td>1997</td>
<td>142.8</td>
<td>15.9</td>
</tr>
<tr>
<td>1998</td>
<td>149.2</td>
<td>15.8</td>
</tr>
<tr>
<td>1999</td>
<td>157.7</td>
<td>15.9</td>
</tr>
<tr>
<td>2000</td>
<td>168.3</td>
<td>15.6</td>
</tr>
<tr>
<td>2001</td>
<td>215.6</td>
<td>18.1</td>
</tr>
<tr>
<td>2002</td>
<td>291.1</td>
<td>22.1</td>
</tr>
<tr>
<td>2003</td>
<td>403.3</td>
<td>28.1</td>
</tr>
<tr>
<td>2004</td>
<td>609.9</td>
<td>31.5</td>
</tr>
</tbody>
</table>

**Table 2.1**  **Source:** Totals compiled by the Congressional Research Service

As described earlier, the balance of payments represents the balance between the capital and current accounts. As such, the chart provided above shows how it is apparent that China has been experiencing dramatic annual surpluses as a result of the incredible amount of forex reserves it has accumulated. Beginning in 1995 after it began to peg the yuan to the dollar, forex reserves spiked to staggering figures and this surplus, which China has accumulated, is in direct correlation to the unprecedented deficit the U.S. has stacked up.
Understanding the dynamics of this complicated economic relationship, accusations of manipulation and currency undervaluation are justifiably put into perspective. Thus, U.S. calls for reform and a balanced exchange rate policy are understood. However, China continued this practice until 2005, and despite increased demands and pressure from Congress, the country was never cited for currency manipulation since its last report in 1994.

2.4 CURRENCY BASKET EXCHANGE RATE

Chapter two, up to this point, has outlined the evolution of China’s currency regime since major reform in 1979. The information provided thus far should serve as a sufficient backdrop which enables the reader to see how China has made improvements and modifications since its initial commencement of a dual exchange rate system, criticism and intense American pressure notwithstanding. Appropriately, akin to its first and second announcements of reform, on July 21, 2005 China revealed its new currency regime and declared a new way forward in its attempts to, according to the public announcement from the Peoples Bank of China (PBOC):⁴⁴

“Establish and improve the socialist market economic system in China, enable the market to fully play its role in resource allocation as well as to put in place and further strengthen the managed floating exchange rate regime based on market supply and demand.”

China’s new currency regime no longer allows the yuan to be directly pegged to the dollar with the intention of improving flexibility of its exchange rate. This decision

⁴⁴ The Peoples Bank of China is the central bank of the People's Republic of China (not to be confused with the Bank of China or the Central Bank of China) with the power to control monetary policy and regulate financial institutions in mainland China.
came amid tremendous pressure from China’s leading trading partners predominately, the U.S., Europe, and Japan, in an effort to minimize mounting trade deficits. Accordingly, the PBOC announced that China would, upon implementing a new currency regime, do four things:\footnote{See Peoples Bank of China (2005) Public Announcement of the People’s Bank of China on Reforming the RMB Exchange Rate Regime}

1) Convert the exchange rate system to a “managed floating” exchange rate regime based on market supply and demand of a basket of currencies.

2) Announce the closing price of a foreign currency traded against the yuan in the inter-bank foreign exchange market after the closing of the market on each working day, and will make it the central parity for the trading against the yuan on the following working day.

3) Readjust the exchange rate of the dollar against the yuan to 8.11 yuan per dollar, which amounted to a slim appreciation.

4) Allow the daily trading price of the dollar against the yuan in the inter-bank foreign exchange market to float within a range of 0.3 percent around the central parity published by the PBOC.

The primary modification made on China’s behalf is the first reform which implements the basket of currencies. However, while this is an adjustment from pegging the yuan to the dollar, this system doesn’t constitute a free floating currency. In fact, it does exactly what the announcement states, it closely manages the degree at which the yuan floats by placing it against specific currencies in a basket. As stated earlier, any true free-floating currency would be subject to float against the supply and demand of all
currencies, a basket of arbitrarily selected currencies, this method essentially controls tightly the fluctuation of a country’s currency.

Some economist considered the second reform to be the most ambiguous and uncertain piece of the PBOC’s announcement. The reasoning for such claims of ambiguity is tied to the fundamental idea of announcing the daily closing rates announced by the central bank. Basically, the dollar, euro, Japanese yen, and South Korean won serve as the dominate currencies in the basket, the daily announcements are aimed to unveil the price at which these currencies traded against the yuan which is intended to thus make it clear as to what central parity of each currency will be traded against the yuan the following day. However, as Takatoshi points out, this is not actually being reflective of the aggregate rate of the currencies in the basket rather, each currency is in actual fact being closely managed against the yuan.

For over a decade China pegged the yuan to the dollar, and for the majority of that time, at a rate of 8.28 against the dollar. If you take its third reform at face value, this two percent readjustment of the yuan to 8.11 against the dollar represented an appreciation of very modest proportions. Nonetheless, it is the opinion of this thesis that this appreciation was a gesture to signify what could but not necessarily be expected with the new currency regime in place. As research provided later in this thesis will highlight, this contemporary regime has yet to yield the results originally anticipated subsequent to the announcement from the PBOC.

In theory, the final reform announced by the PBOC is what many economists considered to be the most promising as it relates to the appreciation of the yuan, albeit at

---

46 See Takatoshi, ITO (2005) The Chinese Currency Reform and East Asia: Steps Toward Regional Exchange Rate Stability
a very gradual pace. This optimism is due to the fact that the new regime would allow the yuan to appreciate to at most, 0.3 percent in a day. Granted this percentage represents appreciation at a snails pace, it however could accumulate to a sizable appreciation over an extended period. The chart below provides an illustration of how the yuan would appreciate if the Chinese authorities were to allow the hypothetical daily increase in value of 0.3 percent.

**Chart 1: U.S. Dollar Exchange Rate for the Yuan**

*Monthly, July 2005 - October 2007*

*Yuan Revalued*

*40 Percent Appreciation*

*Hypothetical value of the Yuan derived by assuming full 0.3% maximum daily appreciation against the USS, as announced by the People's Bank of China on July 21, 2005.*

**Figure 2.2**  
**Source:** The China Currency Coalition
If you consider a hypothetical scenario where the yuan reaches its daily maxim band of 0.3 percent, the cumulative appreciation of the yuan could amount to 6 percent over the period of a month and 20 percent over three months. Certainly if this hypothetical in all actuality was the standard practice of the current regime, the current criticism from the U.S. would most certainly be more conciliatory.

Aside from the closely managed float provided with the current regime, another issue at hand deals with the amount of weight at which China places on each currency represented in its basket. Understanding this amount would signify how freely China is allowing the yuan to float. For instance, a large percentage of weight on the dollar would suggest that the yuan, while not completely, is still very closely pegged to the dollar. Given that China has never disclosed the amount of weight it places on each currency, many economists have come up with a variety of unique research methods to get as accurate account as possible of how much the yuan is weighed against the dollar in China’s currency basket.

One of the latest research analyses performed was in the summer of 2007 at the National Bureau of Economic Research by specialist Jeffrey Frankel and Shang-Jin Wei. In their research they found that, despite the yuan’s appreciation against the dollar since reform in 2005, the Chinese currency appears to be more tied to the dollar than any other currency in the basket, including the fairly robust euro and Japanese yen. Through their regression-based estimates, they were able to find empirical data which supports their conclusion that the yuan’s estimated weight on the dollar is about 90 percent. In addition, out of the 11 known currencies that China maintains is included in the basket, the U.S.

47 See Takatoshi, ITO (2005) The Chinese Currency Reform and East Asia: Steps Toward Regional Exchange Rate Stability
dollar and Malaysian ringgit were the only two currencies whose weight were steady enough to determine any statistically significant conclusion. Ironically, their research found the euro and yen to receive zero weight in the basket of currencies.\footnote{See Frankel, Jeffrey & Wei, Shang-Jin (2007) Assessing China's Exchange Rate Regime. Pg 22}

While their research concluded that the yuan follows closely to a similar resemblance of a currency peg, this thesis falls short of identifying the currency basket regime as such. In fact, subsequent research in this thesis seeks to recognize the importance of China's reforms made thus far as being in line with an all-encompassing reform of this country's currency regime.

2.5 Concluding Thoughts

The aim of this section was to not only provide the reader with an understanding of China's third major exchange rate reform and its four encompassing modifications, but to also bring to light the inherent flaws of each modification that for many is the cause of criticism. For all intents and purposes, the flaws described in this section were expected to provide a viewpoint from which many critics, primarily the U.S., assess China's current currency regime. Moreover, it is understood that there are many opinions as to whether or not China's implementation of this current policy is making a genuine move towards full reform. The goal was to provide the reader with a fair assessment of China's currency policy and its flaws so that they will be able to ascertain reasonably, their own personal opinion of the concluding views of this thesis.

Generally speaking, China has made significant progress since early reforms in 1980. The initial implementation of a dual exchange rate system proved to be very
beneficial for its developing economy. Moreover, it is the opinion of this thesis that this particular regime, notwithstanding possible success from a fixed exchange rate, was presumably the appropriate system for China during this period. The growth, as a result of the dual exchange rate placed China on a trajectory that promised a more stable and prosperous future economy.

The criticism this thesis has is with China’s extended use of the fixed exchange rate. As stated in the aforementioned sections on fixed exchange rates, this system was designed to assist fragile economies and its use was never intended to be prolonged over an extensive period. China’s extended use of this system has been justifiably perceived as abusive, and warranted the implementation of a new system such as the currency basket regime currently in place.

While China’s contemporary exchange rate regime is to many, a step in the right direction, the inherent flaws mentioned in this chapter may continue to provide room for intense scrutiny. In addition, as policy makers in Washington continue to meticulously mull over options geared toward reducing the massive trade deficit with China, the slight appreciation that the currency basket system offers may not be enough to appease these critics. Thus, the following chapter will provide a full assessment of the alleged problems that U.S. policy makers have with China’s currency regime as it relates to the adverse effects on the U.S. economy.
THE EFFECTS OF AN UNDERSIZED RMB

CHAPTER THREE

3.1 INTRODUCTION

The average value of the RMB in February of 2008 was 7.14 against the dollar. This represented a 13 percent increase in addition to a record level appreciation since China’s implementation of a currency basket in 2005. However, despite this evidence of gradual appreciation, albeit quite meager, policy makers and critics who consider China’s currency policy as an insidious threat to America’s future are increasing their calls for rapid and lofty levels of currency appreciation. In fact, calls for reform have become ever more aggressive even with China’s most recent and more assertive reform in 2005.

Given the passionate calls for reform, it is fair to say that there is a genuine concern as to what effect America’s economic relationship with China has on the U.S. economy. These concerns are evident when you speak with many Americans about jobs, trade, the value of the dollar, and the U.S. trade deficit. With strong conviction, you will hear many Americans blame China for the loss of domestic jobs in America due to a mass exodus of more labor-intensive occupations, for the closure of domestic companies due to cheap labor and products flooding the market, and a mounting trade deficit due to an undervalued RMB. In addition, since the U.S. is apparently losing everything to China this obviously explains the most recent downturn of the dollar. Right?

These concerns of everyday American’s prove that China’s economic practices is no longer just a perplexing policy concern deliberated amongst policymakers in Washington, rather, an issue that has extended to the dinner tables and shopping malls

49 See Zhixin, Dong (2008) Yuan breaks 7.15-mark against dollar
across America. This broad pool of concern and increased focus on China's economic practices validate the importance of this thesis topic. For this reason, it is the intention of Chapter four to evaluate the real threats and unfavorable consequences for America that may be associated with China's currency valuation.

However, it is hard to find a subject in America, which does not have a counter argument that necessitates consideration, and China's currency regulation is no exception. In spite of the fact that many Americans sincerely view China as an economic threat, several others consider the U.S.-Sino economic relationship as a tremendous benefit to the American economy. In fact, many economists give credit to inexpensive goods and services from China as the underlying rationale for low prices and the reduced risk of inflation here in the U.S. 50 Furthermore, these economists feel that benefits provided from this economic relationship overshadow the adverse effects that could be enumerated from the many skeptics. To provide the reader with a balanced perspective of the threats and benefits for America, this chapter will also measure the level at which China's economic policy has served as an asset for the U.S. economy.

Chapter 3 will maneuver down the trail of the good, the bad, and the ugly as it relates to how China's currency regulation affects the U.S. The scope of the research will primarily focus on the U.S.-Sino trade imbalance, U.S. debt with China, and the value of the U.S. dollar and China's impact. Upon completing this chapter, the reader should be able to clearly identify their position as to how China's currency policy affects the U.S. Also, identifying their position will further enable the reader to properly assess the policy prescriptions discussed later in this thesis.

50 See Hill, Carla and Blair, Dennis (2007) U.S.-China Relations: An Affirmative Agenda, A Responsible Course
While it is important to identify and fully understand the opinions of the different economists and policymakers, it is equally essential to organize them in a way where you can align the varying viewpoints. Question number two does this by identifying the stakeholders and thus placing the varying calls for reform into a much better perspective.

3.3 POLICY IMPLICATIONS FOR U.S. TRADE

The most recognizable impact of U.S. interaction with China is through trade. American consumers come in direct contact with this fact while doing what they are known for doing better than most other foreign consumers, shop. However, during the 1980s and 1990s many Americans when purchasing a variety of merchandise could hardly disregard products that carried the tag made in Taiwan or Japan. Today, a vast amount of those same brands and types of products are accompanied with a made in China tag. Is this good or bad?

No one can doubt the fact that U.S. trade with China is increasing at a phenomenal pace. The most recent trade reports reveal that at the end of 2007 China became the largest source of American imports with $321.5 billion in Chinese goods. This surge is indicative of the American interest in cheap goods from China which have become more sophisticated and include more high tech products such as computers and flat panel television screens. Mark Drajew, in the Bloomberg news recently analyzed the fact that trade with Mexico following the NAFTA trade agreement did not even accelerate at the rate currently experienced between that of the U.S. and China.

Many economist worried about the impact that such an increase in trade with China has on the U.S. do not go as far as to condemn this important exchange with China,
rather the balance of trade, or the lack thereof, between both countries.\textsuperscript{51} This lack of balance in trade between both countries is established due to the fact that China imports much less of American goods compared to that of what the U.S. imports from China. This type of imbalanced trade relationship between the U.S. and China is illustrated in the chart below.

**U.S. Merchandise Trade with China: 1980-2007**  
($ in billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. Exports</th>
<th>U.S. Imports</th>
<th>U.S. Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>3.8</td>
<td>1.1</td>
<td>2.7</td>
</tr>
<tr>
<td>1985</td>
<td>3.9</td>
<td>3.9</td>
<td>0</td>
</tr>
<tr>
<td>1990</td>
<td>4.8</td>
<td>15.2</td>
<td>-10.4</td>
</tr>
<tr>
<td>1995</td>
<td>11.7</td>
<td>45.6</td>
<td>-33.8</td>
</tr>
<tr>
<td>2000</td>
<td>16.3</td>
<td>100.1</td>
<td>-83.8</td>
</tr>
<tr>
<td>2001</td>
<td>19.2</td>
<td>102.3</td>
<td>-83.1</td>
</tr>
<tr>
<td>2002</td>
<td>22.1</td>
<td>125.2</td>
<td>-103.1</td>
</tr>
<tr>
<td>2003</td>
<td>28.4</td>
<td>152.4</td>
<td>-124.0</td>
</tr>
<tr>
<td>2004</td>
<td>34.7</td>
<td>196.7</td>
<td>-162.0</td>
</tr>
<tr>
<td>2005</td>
<td>41.8</td>
<td>243.5</td>
<td>-201.6</td>
</tr>
<tr>
<td>2006</td>
<td>55.2</td>
<td>287.8</td>
<td>-232.5</td>
</tr>
<tr>
<td>2007</td>
<td>65.2</td>
<td>321.5</td>
<td>-256.3</td>
</tr>
</tbody>
</table>

*Table 3.1 Source: Congressional Research Service*

What table 3.1 illustrates is that China began to run an initial trade deficit with the U.S. between 1985 and 1990, its minimal significance compared to today notwithstanding. This thesis makes an important note of the fact that, as mentioned in

\textsuperscript{51} Jacoby, Jonathan & Logan, Amanda (2007) Dealing with the Trade Deficit
chapter 2, this period represents approximately the exact time that American policymakers and critics began to ratchet up criticism of China’s currency practice, and accusations of manipulation became common. The fundamental premise for the critic’s argument lied in the imbalance of trade between both countries. As a growing Chinese trade surplus became evident, American critics grew apprehensive. However, these critics were not necessarily uneasy over China’s emerging surplus with the U.S. rather, the currency regime that China employed which fueled such a surplus. Thus, it was during this time that the U.S. passed the 1988 Omnibus Trade and Competitiveness Act, and for five times, consecutively reported China as a currency manipulator, which subsequently compelled officials to reform the country’s currency regime.

**U.S. Merchandise Trade Balances with Major Trading Partners: 2007**

($ in billions)

<table>
<thead>
<tr>
<th>Country or Trading Group</th>
<th>U.S. Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>-791.0</td>
</tr>
<tr>
<td><strong>China</strong></td>
<td><strong>-256.3</strong></td>
</tr>
<tr>
<td>European Union (EU27)</td>
<td>-107.4</td>
</tr>
<tr>
<td>Organization of Petroleum Exporting Countries (OPEC)</td>
<td>-127.4</td>
</tr>
<tr>
<td>Japan</td>
<td>-82.8</td>
</tr>
<tr>
<td>Canada</td>
<td>-64.7</td>
</tr>
<tr>
<td>Mexico</td>
<td>-74.3</td>
</tr>
<tr>
<td>Association of Southeast Asian Nations (ASEAN)</td>
<td>-50.6</td>
</tr>
</tbody>
</table>

**Table 3.2**  **Source:** Congressional Research Service

Today, American critics are calling for aggressive reform akin to that of the early 1990’s, which would essentially force China to appreciate the RMB. This is largely due
to the totals shown above in table 3.2, which illustrates America's merchandise trade balances with its major trading partners. From this table it is not difficult to comprehend how critics could become anxious. For the most part, notwithstanding the fact that America's total world debt is exceptionally high, the primary concern is the disproportionate amount of China's trade surplus with the U.S. According to the data above, not only does China boast the largest trade surplus with the U.S., its total equals more than that of the 27 European Union and 13 Organization of Petroleum Exporting Countries combined.

Some economists assert that it is this substantial trade imbalance, which consequently hurts the American economy by contributing to the loss of employment in important sectors such as the manufacturing industry.\textsuperscript{52} In fact, the Economic Policy Institute recently conducted a study and labeled the states whose employment base were most affected as a direct result of this trade imbalance.\textsuperscript{53} For many, this not only affects employment but domestic industries in the U.S. as well. Given that, according to the EPI study, millions of American jobs from various sectors are being transported to China, this essentially reduces domestic production capacity in the U.S.

American critics who fear possible adverse effects on the U.S economy as a result of such an unprecedented trade surplus, assail China's currency regime as the underlying problem. They assert that, despite reform in 2005 to reflect some level of supply and demand, China artificially manages the value of the yuan against the dollar and this hurts the U.S. economy. In fact, some economists have determined that, based on trade weight,
the yuan is undervalued around 20 to 35 percent.\textsuperscript{54} Because the yuan is valued significantly lower than the U.S. dollar, many U.S. companies cannot compete with the cheap products and labor Chinese companies are able to offer and produce. Therefore, since many critics believe that the RMB is undervalued, the logical solution would require China to appreciate its currency at a level more representative of market supply and demand.

In the event that the yuan appreciated, its value against the dollar would also increase and the result would mean cheaper American goods for Chinese consumers. Today, American consumers purchase an enormous amount of goods from China because they are able to get more for their dollar, thanks to the benefits of a cheap yuan. Therefore, the trade disparity exists because American consumers are purchasing an exorbitant amount goods from China because they are cheap while conversely, Chinese consumers are less inclined to purchase goods from the U.S. at comparable levels since they are more expensive. It would logically follow that if the value of the yuan increased against the dollar, subsequently decreasing the price tag on American goods, the roles of both consumers would reverse. Given that there would be an increase in American goods purchased by Chinese consumers and the opposite scenario for the American consumer, the result would be a reduction in the U.S. trade deficit. To many economist and policymakers, this sounds like a rational solution however, there are others who view this as short sighted and the wrong way to go.

\textsuperscript{54} See Goldstein, Morris (2006) Renminbi Controversies
Contrary to job losses and a threat to the U.S. economy, other economists view U.S.-Sino trade as mutually beneficial for both countries in two ways.\(^5\) First, the standard of living for many Americans has increased as a result of a lower valued yuan. The premise behind this argument is that many more Americans are able to purchase goods at much cheaper prices than would be possible if critics were successful in their attempts to appreciate the RMB. Secondly, major American corporations who compete with other foreign companies benefit as an increased number of U.S. products are purchased from a country with over a billion consumers. In fact, as a direct result of trade with China, the United States is about $70 billion wealthier per year.\(^6\) With such a large population, as an increased number of this consumer base began to purchase more U.S. goods, trade with China over an extended period could prove extremely beneficial to the American economy. Therefore, while there are some affected more than others in the U.S., the overall fabric of American society benefits from this mutual relationship between both countries.

It is argued that simply appreciating the RMB would not be the silver bullet that ultimately reduces the U.S. trade deficit. While it is a given that this action would decrease the U.S. trade deficit with China, many economist assert however, that the reduced debt with China will simply be redistributed to other Asian economies.\(^7\) The fact, which corroborates this assertion, is that surrounding Asian nations also artificially maintain a low valued currency in order to compete with China. If there is not a combined appreciation of currencies among these countries, China as the major player,

---

\(^6\) See Bergsten, Fred et al. (2006) The Balance Sheet: China, pg 10
\(^7\) See Wing Thye Woo & Xiao, Geng (2007) Facing Protectionism Generated By Trade Disputes: China’s Post-WTO Blues
will be the only country affected. Moreover, the surrounding countries will be rewarded, as they would subsequently be the beneficiary of an influx of U.S. importers and debt. In the end, the U.S. would be successful in decreasing its debt with China, but with a low savings rate, American consumers would undoubtedly began to purchase products from another Asian country who could deliver the same products at the same cheap price. However, there are some economists who decry calls for China to accelerate appreciation of the RMB and consider these calls precarious.

3.4 POLICY IMPLICATIONS FOR CHINA’S HOLDINGS OF U.S. SECURITIES

The U.S. merchandise trade deficit is not the only U.S-Sino economic imbalance in which many policymakers have overwhelming concerns. An undervalued RMB not only contributes to the running U.S. trade deficit with China due to disproportional export/import ratios, it also plays a significant role with regards to China’s holding of U.S. securities.\textsuperscript{58} As mentioned in chapter two, China still maintains a tight peg on the dollar, albeit indirectly through its currency basket regime. In order for China to maintain the yuan at a certain level to the dollar, authorities must purchase a corresponding amount of U.S. dollars and securities.\textsuperscript{59} According to the U.S. Department of Treasury’s report on major foreign holders of treasury securities, in February of 2008 China ranked second behind Japan with a total $486.9 billion.\textsuperscript{60} Just over a decade ago,

\textsuperscript{58} According to the Congressional Research Service, the U.S. currently maintains a running federal debt of $9 trillion. This represents the highest level of debt in American history, however, the U.S. government uses treasury securities to help finance the federal debt.

\textsuperscript{59} Since U.S. dollars do not earn interest, China has purchased large numbers of securities that includes debt from the U.S. Treasury, various agencies, equities, and corporations.

\textsuperscript{60} See Department of Treasury, Major Foreign Holders of Treasury Securities Holdings, 2008.
China ranked seventh overall in holdings of U.S. securities, and between 2005 and 2006, it raked in the largest increase of U.S. securities ever by any country with a total of $172 billion.\(^{61}\) What this shows is that despite reform in 2005 to a currency basket regime, the yuan still pegs closely to the dollar and as many would agree, it is still very much undervalued.

Given China’s vast amount of foreign exchange reserves, the concerns of many American policymakers have increased as they mull the possible implications that could arise as a result of China’s mass accumulation of U.S. securities. It is a fact that if China were to appreciate its currency at a higher level than what it allows through its currency basket, in addition to allowing the RMB to float freely in the free market, it would not have the capacity to purchase the amount of U.S. securities and assets that it has. It is because of this fact that many critics disparage China’s economic practices as manipulative and a threat to the U.S. economy.

The primary danger that concerns many policy makers is the potential for China to sell substantial amounts of its U.S. securities, a situation commonly referred to as the “Nuclear Option.” This would mean that China sells its U.S. holdings to other foreign or domestic investors who could possibly require much higher interest rates above the existing level. The subsequent events that would ensue, as a result of such a reduction of U.S. securities, is what concerns many critics.

In 2007 the idea and perception that China could potentially exercise its right to unload its holdings of U.S. securities in massive numbers was at its height. This was primarily due to an article that ran in a London publication, *Telegraph*. The publication

quoted two Chinese officials who directly acknowledged China’s potential to use its massive holdings of securities as leverage against the U.S. Specifically, the officials made the following comments.\(^{62}\)

"Beijing's foreign reserves should be used as a "bargaining chip" in talks with the US." -Xia Bin, Finance Chief at the Development Research Centre

"China has accumulated a large sum of US dollars. Such a big sum, of which a considerable portion is in US treasury bonds, contributes a great deal to maintaining the position of the dollar as a reserve currency. Russia, Switzerland, and several other countries have reduced their dollar holdings. China is unlikely to follow suit as long as the yuan's exchange rate is stable against the dollar. The Chinese central bank will be forced to sell dollars once the yuan appreciated dramatically, which might lead to a mass depreciation of the dollar."

-He Fan, Official at the Chinese Academy of Social Sciences.

These particular statements drew criticism from many policy makers and augmented the concerns about the potential danger that China’s so-called nuclear option could have on the U.S. economy. In addition, the concerns of such an action elevated the debate in Congress as to what legislative options could be implemented to ward off China’s ability to follow through on the threats mentioned above, if there was an opportunity. These legislative options will be discussed further in chapter five.

However, despite the anxiety that these comments caused for many policymakers on Capital Hill, some economist assert that China’s nuclear option would not totally derail the U.S. economy. The primary reason is deeply rooted in the robust and resiliency associated with the U.S. economy. Quite frankly, the credibility of the U.S. economy carries a substantial weight within the global economy and such an attempt could backfire on China. Notwithstanding, the short term effects such as a decline in the values of the dollar and increase in interest rates, the risks associated with such a move prove to be against China. Given that China holds a massive level of U.S. debt, if the value of the dollar were to decrease dramatically, China stands to lose a substantial amount of financial capital. A lower value dollar would not carry the same weight as it once did prior to China unloading large quantities of U.S. securities. Therefore, the debt is not just a problem for the U.S. and if China intends to collect a large return on its investment in the U.S. economy, the nuclear option would conversely, provide exactly what it does not want.

3.4 CONCLUDING THOUGHTS

Chapter three covered some of the leading policy implications that an undervalued RMB pose to the U.S. economy. Indeed, there are a number of other issues which pose legitimate threats such as sovereign wealth funds and the unprecedented expansion of global financial assets. However, as this chapter followed closely with the scope of this thesis that focuses on China’s currency value specifically, you cannot neglect the credible concerns of many policymakers and the general American public.

---

While these threats are evaluated and solutions to resolve China’s undervalued currency are deliberated, it is important for policymakers to understand that, as this chapter has elaborated, opinions vary on the policy implications posed to the U.S. economy. Furthermore, quick and hasty action from the U.S. in response to what is perceived as a considerable threat could backfire. In addition, China understands that it is not in the best position to make any hasty decisions in an attempt to retaliate against the U.S. As mentioned above it runs the risk of taking on more damage to its economy than what the U.S. would face given the amount of U.S. debt that it holds.

To this, both country’s must work together to solve any differences that may arise between the two economies. Indeed, there are policy implications that currently exist as a result of an undervalued RMB, however there are also many benefits as well. It is important that policymakers make balanced judgments that are reflective of both the good and the bad. The policy implications that exist today could soon be an afterthought if policymakers move forward toward improving the long-term interest with regards to the U.S. - China economic relationship.
CASE STUDY: IS THE U.S. REACTING TO A REAL THREAT

CHAPTER FOUR

4.1 INTRODUCTION

Chapter three highlighted the extreme differences in views as to how China’s currency regulation affects the U.S economy. In addition, it explained how the clear dichotomy of views is motivated by a variety of interest and expectations. However, it is interesting how many Americans today feel that China is the only elephant in the room that is the problem. This thesis takes particular interest in how the presumed Chinese threat overshadows the fact that other countries not only run similar trade surpluses with the U.S., albeit China has the largest, but also peg their currency to the dollar, and are the recipient of sizable stocks of U.S. securities.

Since the beginning of the 21st Century, China has undoubtedly been the principal recipient of American pressure and demands for currency appreciation. These intense calls for reform from politicians reverberate across the U.S. and further augment American anxiety toward China. In addition, demands and finger pointing have increased despite the fact that some surrounding Asian economics undervalue their currency at comparable levels to China. With that said, this leads to an important question as to what is unique about China that makes this developing economy the prime target for U.S. scrutiny and allegations. Moreover, does China’s reluctance for hasty appreciation truly place it on an
ominous track toward derailing the U.S. economy or could this situation turn out to be pure presumption and speculation?

4.2 METHODOLOGY

Understanding the factors that contribute to the present apprehension of many Americans regarding China’s currency regulation is essential. This thesis, through the use of an embedded single case study design, aims to determine these factors and their link to understanding whether U.S. calls for hasty appreciation of the RMB are representative of a real and apparent threat. Given that this thesis is limited to the amount of control over the current variable (China) in question, a case study design provides the best opportunity to research contemporary events relating to China’s currency valuation from a more historical prospective.

History serves an essential tool for this case study due to the fact that China is not the only country to have experienced such pressure for currency reform from the U.S. Approximately twenty years ago Japan underwent similar scrutiny from the U.S. regarding its currency valuation as the country’s economy expanded and, akin to contemporary claims about China, was considered a possible economic rival to the U.S. Observations from this particular phenomenon offers many parallels which make significant contributions to the arguments and opinions of this case study. In addition, likening contemporary events regarding China’s currency valuation to Japans historic episode offers one of the few analogous views into how the U.S. should move forward and why.
The leading theory expressed by advocates for accelerating appreciation of the RMB is that this action will decrease the U.S. trade deficit with China, the result being a more equitable exchange between both economies. This thesis does not dispute this fact. As stated earlier in this research, appreciating the yuan against the dollar makes Chinese goods cheaper and American goods more expensive. The inevitable outcome results in the increased consumption of American goods and the opposite for Chinese goods, hence a reduced U.S. trade deficit with China. Therefore, it is not the expectation of this case study to test this particular theory rather, if there is a reasonable need to advocate for such policy.

The principle intent of this case study is to find answers to the following questions:

1) Does China’s currency regulation represent a pattern or trend, which signifies a true threat to the U.S. economy?

2) Are there any parallels that warrant an aggressive response from the U.S?

3) What could the implications be for currency appreciation?

China and Japan both provide a unique situation from which to study because each country has been under the currency microscope of major U.S. scrutiny and considered a threat to the U.S. economy. By finding an answer for question number one, this thesis will be able to determine a causal relationship between a developing economy’s currency practices and the U.S. response that
such practices may incite. In addition, uncovering an answer for this question is essential as the first step of this case study, because it provides a reasonable backdrop from which the reader can postulate two things:

I. What the indicators are that signal a potential threat and as a result provoke a response from U.S. policymakers.

   i. Essentially, when you compare the events that roused U.S. criticism toward Japan's currency valuation you gain invaluable insight into what causes the U.S. to be apprehensive toward China's current practices.

II. What may be the severity of the threat to the U.S. economy and are the calls more reactionary than necessary.

   i. Uncovering the events that ensued as a result of U.S. pressure on Japan to appreciate the yen may present the case that Japan's economy was much weaker than what many critics believed. With that said, China may have a number of internal adjustments to make before major appreciation, and calls for aggressive reform, while well intended, may be overly cautionary.
There is no better teacher than history and abiding by this statement enables this case study to analyze fully the way at which the U.S. dealt with Japan over twenty years ago. This case study tracks Japan’s economic growth in addition to the expansion of its trade deficit with the U.S. It also tracks how the U.S. responded to Japan’s growth and the perceived threat that ensued from its original reluctance to accelerate appreciation of the yen. Question number three attempts to discover the response needed by likening Japan’s case to the current situation with China.

Question number four follows by tracking the results of Japan’s historical appreciation to get a sense of the implications that are possible as result of accelerating appreciation of the RMB. Japan’s economy experienced a number of fluctuations and this case study details how appreciation affected the country’s economy at that particular time. It also focuses on the influence the U.S. had as Japan’s economy was in flux and what were the implications from this bilateral exchange.

Given that Japan was the major focus of U.S. pressure during the 1970s and 1980s, this case study has the benefit of a significant long-term view from which to track its downturn and improvements since major appreciation. In doing so, it is possible to project what long-term implications may be possible with regards to the potential for accelerated appreciation of the RMB. The information as a result of this particular research makes an invaluable contribution to the recommendations that will follow from this case study.

The argument of this case study is summarized by the following propositions:
1) U.S. pressure should not cease but possibly be used in a way that guarantees continual commitment to appreciation. However, overly excessive appreciation could prove deleterious to the Chinese economy at a time in which growth and expansion is dually beneficial for China and the U.S.

2) Japan offers evidence that any appreciation of the RMB should be gradual and in a way that prevents disruption of the market and consequently, reduced confidence in the Chinese economy. Similar to Japan, investment and exports are crucial to the survival of the Chinese economy, which leaves this budding economy vulnerable to shocks. Anything other than a gradual approach could dissuade investment and even further, damage China’s export market.

3) The U.S. must continue to take advantage of the U.S.-China Strategic Economic Dialogue (SED) as a vehicle to hold China to its commitment for currency appreciation. If all diplomatic dialogue and multilateral engagement is unsuccessful, then unilateral action may be necessary.

The one constant amid the dichotomy of opinions as to what is the best way to deal with China’s currency valuation is the well-known fact that its economic policies have an indirect effect on the American economy. The level of the effect is very much subjective but the way in which the U.S. responds is essential. That is why it is the goal of this case study to determine the type of
response needed to deal with China’s currency valuation. Lastly, the research that will follow from this embedded single case study design will seek to determine if an undervalued RMB is truly an immediate threat to the American economy.

4.3 JAPAN IN BRIEF

It is common today for most people to identify China as the preeminent power from Asia and a prospective economic rival to the U.S. However, it was not too long ago in history when Japan occupied this coveted role as the country was presumed to be on a path toward economic dominance. Nonetheless, Japan later experienced a major economic downturn that left its economy stagnant and shaped a dim forecast for the future. In fact, some had given up on Japan, as the country’s leadership was reluctant to shelve some of the economic policies and put an end to many of the superfluous bureaucracies, some of which proved to be a heavy anchor that effectively prevented the country from rising above its problems.

Following a disastrous defeat by the Americans during World War II, Japan’s leadership began to focus on rebuilding the country’s economy in a way that would ensure its resurgence as a strategic player in the international community. Several of Japan’s initial policies such as protection and promotion and fixed exchange rates against the dollar actually proved helpful as the country began a gradual recovery. The policies enabled the country to increase substantially its exports while simultaneously protecting its domestic industries from aggressive importers. Indeed, they were invaluable for Japan’s growth and without such policies, its infant industries would have

---

64 Policies aimed at protecting and promoting foreign investment through legally-binding rights and obligations. This enabled Japan to boost their export industry by promoting cheap goods while protecting their domestic market from outside competition.
had a tough time competing in an exceedingly antagonistic market. Yet, these same policies would later prove to be an inconvenience as Japan’s future leaders would fail to suspend aging and inessential practices rather than adjusting and strengthening the country’s market forces. In addition, years of implementation would augment U.S. resentment, as these policies were perceived to be jeopardizing the U.S. economy.

If you analyze Japan’s auto industry, you will be able to gain a better understanding of how inequitable the country’s economic and trade policies were toward the U.S. For the most part, before the introduction of Toyota in 1937, Ford, the dominant American made vehicle at the time, accounted for three-quarters of the cars in Japan. However, subsequent to the implementation of Japan’s WWII policies and 50 years of protectionism and an undervalued yen, the number of Fords on the road in Japan reduced to zero. On the other hand, Toyota sales surged domestically and internationally, particularly in the U.S. where consumers grew a fondness for the cheap price tag and its dependability. However, Japan’s economic policies proved to agitate the U.S., as many critics believed they were taking a direct toll on the American economy.

During the 1980’s, Japan’s economy grew faster than any other industrialized economy, and if the country had managed to sustain its level of growth, some economist believe that Japan would have been the world’s richest nation. However, foreign investors became increasingly frustrated as Japan maintained what they considered unjust economic policies and many investors found it extremely difficult to gain entry into the Japanese market.

---

66 The yen is the currency of Japan. It is currently the third most-traded currency in the foreign exchange market after the United States dollar and the euro.
67 See Friedman, Thomas (1995) Foreign Affairs; Japan Fatigue
The 1990s proved to be a disastrous decade for Japan’s economy and overall stature in the international community. What once was a system that other countries attempted to emulate and model their economic systems after, soon became the system that failed and failed horribly. In 1990 Japan soon began to experience mounting deflation as well as problems in the stock market. In fact, between 1991 and 2003 a total of 180 banks would fail.\textsuperscript{69} Additionally, in 2001 alone, the Japanese banks wrote off $60 billion in bad debts.\textsuperscript{70} There a variety of monetary policies that played a role in Japan’s economic situation and required assertive approaches such as privatizing the state owned banks to address some of the deep-rooted problems. However, for the purpose of this thesis, the effects resulting from appreciation of the yen will be the focal point.

Many economists assert that China is on the receiving end of comparable American criticism and apprehension akin to Japan’s experiences during the 1980s.\textsuperscript{71} This parallel offers an ideal historical comparative from which to study any avoidable patterns or opportunities overlooked as increased attention focuses on the unfavorable issues of the U.S.-China bilateral exchange.

4.4 IS THERE A PATTERN OR TREND OF A THREAT

It is 2008 and China has accumulated a massive trade deficit with the U.S., is the holder of a large stock of U.S. securities, and most importantly maintains a currency value that many economists from the U.S. and other developed nations, consider as extremely undervalued. The value of the dollar is in flux though definitely, in a

\textsuperscript{69} See Hossain, Monzur (2005) Can Japan Avert any Future Banking Crisis. pg 425
\textsuperscript{70} See Decker, Brett (2002) The Incredible Shrinking Prime Minister; After Promising A Revolution of Reform, Japan’s Junichiro Koizumi is Just More of The Same
\textsuperscript{71} See Brown, Chad & McCulloch, Rachel (2005) U.S. Trade Policy Toward China: Discrimination and Its Implications
downward spiral, American companies are frustrated with competing against cheap
Chinese products flooding the U.S. market on an increasing level each year, and China,
the economy that the U.S. played a principle role in revitalizing, now has the title of
Chief Lender for American deficit spending.

Given the current state of affairs, many Americans find themselves indignant, and
rightfully so, since that they feel this makes the economy vulnerable. In addition, there is
the feeling that China has an unfair advantage, as many economists have demonstrated
how a higher valued RMB would reconcile the disparities in bilateral exchange between
both economies. This cotemporary Chinese threat has eerily similar parallels to the
Japanese threat of the 1980’s. The sheer resemblance between the 1980 and 2005 Times
Magazine news article included in this thesis, displays this very fact.\textsuperscript{72}

The difference between today’s Japan and that of the 1980’s is that the fear of a
looming threat is no longer the leading fodder in U.S. policy circles. After enormous
American pressure and influence to appreciate the yen, Japan followed through and
experienced its fair share of instability in the process and now the attention is on China.
Searching for a particular pattern that may have led to U.S. criticism or apprehension will
give insight into whether China is on a more unique and ominous path or experiencing a
trend of scrutiny that should be expected for a developing economy that embarks on a
path of accelerated growth similar to Japan and China. The scope of this section in the
case study will focus primarily on three things:

- Japan and China’s foreign exchange reserves during comparable periods of
growth
- Both countries trade deficit with the U.S.

\textsuperscript{72} See appendix 4.1
The U.S. economic outlook and effects in labor markets

Japan and China, as neighboring countries in the Pacific, have many things in common. One can consider their lengthy history, which dates back to great dynasties and monarchs of their respective periods, or humiliating defeats and occupations of foreign countries. They have also enjoyed above average levels of growth, both of which have amazed economists and provided an increased level of frustration for the U.S. History undoubtedly corroborates the fact that these two countries have shared comparable fates and, in terms of major trade imbalances, history may prove that the U.S. will continue to ratchet up pressure on China until it dramatically appreciate the value of the RMB.

Like China’s second major currency reform, in 1949 Japan unified its currency and began pegging the yen to the U.S. dollar at a rate of 360 yen to each dollar. As described earlier in this thesis how a fixed exchange rate can benefit a developing economy, Japan’s was no different. It began to experience exorbitant amounts of economic growth as new markets opened and its export figures swelled to great levels. Increased growth played a leading role in rejuvenating the Japanese economy in addition to making it possible for this country to become a highly industrialized nation. However, as technologies and industries improved, so did the capacity to manufacture even more goods at cheap prices. Consequently, akin to current events with China, as Japan increased its capacity to produce and export more, American consumption of these cheap goods increased accordingly.

Between the 1960’s and 70’s Japan averaged an annual growth rate of 10 percent, similar to what China is experiencing today. However, in contrast to its

---

73 See Beijing Times (2003) Commentary: Learning from the Japanese Yen
growing economy, Japan also began to build a sizable trade surplus over the U.S. By 1980, the U.S. recorded a trade deficit with Japan of $9.9 billion and during the following year, that number skyrocketed to $15.8 billion in 1981. These unmatched levels of growth in addition to a massive trade surplus during that time are what caused many to begin comparing Japan as a likely future economic rival to the U.S. However, many Americans became apprehensive about Japan's growth, as it appeared to come at the cost of the American economy.

From the brief narrative above this case study separates two key events that represent patterns of a perceived threat when compared to contemporary activities in China:

![Diagram of Perceived Threat To U.S. Economy](image)

Figure 4.1

Earlier research in this thesis pointed to the fact that many economists believe an undervalued currency serves at the underpinning from which above average growth, similar to China and Japan, and extreme trade deficit is possible. So in order to find out whether China's currency regulation represents a pattern or trend that signifies a true threat to the U.S. economy, we must first analyze these two factors.

---

74 See Solarz, Stephen (1982-83) A Search for Balance
Perception plays the primary role in what causes a person or country to feel threatened or susceptible to some sort of nefarious tactics at play by another entity. Therefore, in order to feel threatened there must be an event, person, place, or thing that one perceives to be a threat. For many economists in the U.S., one of the initial indicators of a possible economic threat on the horizon was the massive forex that the both Japan and China began to accumulate. The reason being, that both countries during their respective periods of robust growth pegged their currency to the dollar which in turn, required them to purchase significant amounts of U.S. dollars and securities in order to maintain a particular peg.

Table 4.1: A comparison between Japan and China's growth

<table>
<thead>
<tr>
<th></th>
<th>Foreign Reserves (billion dollars)</th>
<th>Money Supply</th>
<th>Real estate price (land)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Natl. Avg.</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>84</td>
<td>26.5</td>
<td>7.8</td>
<td>2.5</td>
</tr>
<tr>
<td>85</td>
<td>27.9</td>
<td>8.7</td>
<td>2.0</td>
</tr>
<tr>
<td>86</td>
<td>58.4</td>
<td>8.6</td>
<td>2.7</td>
</tr>
<tr>
<td>87</td>
<td>84.9</td>
<td>11.2</td>
<td>9.7</td>
</tr>
<tr>
<td>88</td>
<td>99.4</td>
<td>10.8</td>
<td>7.4</td>
</tr>
<tr>
<td>89</td>
<td>73.5</td>
<td>10.3</td>
<td>7.2</td>
</tr>
<tr>
<td>90</td>
<td>69.9</td>
<td>10.2</td>
<td>13.7</td>
</tr>
<tr>
<td>91</td>
<td>68.2</td>
<td>2.6</td>
<td>3.1</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>02</td>
<td>286.4</td>
<td>16.8</td>
<td>3.7</td>
</tr>
<tr>
<td>03</td>
<td>403.3</td>
<td>19.6</td>
<td>4.8</td>
</tr>
<tr>
<td>04</td>
<td>609.9</td>
<td>14.6</td>
<td>9.7</td>
</tr>
<tr>
<td>05</td>
<td>818.9</td>
<td>17.6</td>
<td>7.6</td>
</tr>
<tr>
<td>06</td>
<td>875.1</td>
<td>19.1</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: Research Institute of Economics, Trade and Industry

Table 4.1 illustrates the levels of forex accumulated by each country during comparable periods of growth. However, for the purposes of this case study more details
are provided in order to give further insight into additional factors that raised U.S. concerns about both countries. What this table shows is that, as both countries accumulated more forex, their money supply increased as well. Given that more money is circulated within the domestic markets and among the general public, one could logically assume that the economy is growing accordingly. To demonstrate further evidence of growth, this table also shows how real estate prices rose to some extent, in accordance with the growth of forex. Basic economic theory makes clear that as demand increases, so does the price of the goods purchased. Therefore, demand increased along with the overall growth of the money supply, hence the soaring real estate prices.

From this information, it is reasonable to ascertain that the standards of living for many citizens from both countries were increasing over a relatively short period of time. However, by no means is an increased living standard of citizens of another country a threat to the U.S. economy. This in fact, improves the international economy, as more people are able to purchase an increasing amount of goods, which in turn, benefits other economies such as the U.S. The threat rests in the fact that, given their improving living standards and maturing economy, these countries continued to maintain what many economists believed to be an undervalued currency. Moreover, as this thesis pointed out in Chapter 3, both countries had to intervene rather aggressively between their BOP accounts to ensure that their currency remained at a certain level to the dollar. In terms of

---

75 The reduced increase Japan’s 1991 real estate prices were due to the bubble burst that the country experienced during that period. The country experienced further reductions as economy problems ensued. The real estate prices for Shanghai in 2006 were abridged as a result of the government imposing a sales tax and other measures to thwart speculators. As China’s economy continue to grow at an elevated level, the government was worried about an overheated economy and the dramatic increase in real estate prices were indicative of how prices could get out of control in not any manageable deterrents.

76 Money supply refers to the total amount of money held by the public at a point in time in an economy.
trade, the net effect of Japan and China's undervalued currency, as illustrated below, amounted to an enormous U.S. trade deficit.

Figure 4.2

Figure 4.3

Source: China Balance Sheet; Center for Strategic and International Studies, Peterson Institute for International Economics
The chart above displays the U.S. trade deficit with both, Japan and China during similar periods of growth, compared to the rest of the world. U.S. criticism towards Japan's currency valuation reached its peak around 1985 resulting in the Plaza accord negotiations in which a dramatic appreciation of the yen ensued. (The 1985 Plaza Accords will be discussed during review of the third question relating to what response is warranted) In addition, criticism toward China's currency valuation reached great intensity around 2004, current demands for reform notwithstanding. This strong criticism resulted in China's third and most recent reform to a currency basket in 2005.

These comparisons present the case that there is a pattern that can be expected when a developing economy attains an above average level of unbalanced economic growth with an undervalued currency such as in the case of Japan and China. To prove this point further, this case study points out the fact that Japan's trade deficit with the U.S. did experience a significant decrease as a result of the yen's appreciation. However, the chart above details another important occurrence. Where the U.S. trade deficit decreased, it increased with China and the rest of the world. This is an important fact as it relates to the conclusion of this thesis. Essentially, while this does provide evidence, as this thesis recommends, that China should make the necessary steps to appreciate gradually the RMB, it also points to the fact that U.S. consumption continues to increase. The trade deficit with China is in large part, due to the fact that the U.S. consumes considerably more goods from China than it does of American goods. It is also most likely the case that, since the RMB is undervalued, American goods are more expensive and the Chinese consumers are more reluctant purchase these goods, while Americans have obviously had no reservations with purchasing cheap goods made in China.
The final findings from this comparison showed that there is definitely a pattern of a perceived threat that can be expected for a country that has a similar experience like Japan and China. Moreover, while this case study points to the fact that the threat may be predicated on speculation, inaction could result in the threat becoming reality. Such as the case with China, if it in fact allows a gradual appreciation of the RMB, its trade deficit with the U.S. will shrink. However, if the U.S. does not take measures to slow consumption to a manageable level, the trade deficit will only be redistributed to another developing country that can produce goods at similar cheap prices.

As stated earlier, the first pattern of a perceived threat is speculated primarily by economists who closely monitor the U.S economic outlook. The second pattern on the other hand hits closer to home for many U.S. consumers. Issues such as the loss of jobs, recession or other forms of a poor economic outlook, and a decrease in value of the dollar, are subjects that directly affect the American public. For many Americans, the issue of an undervalued RMB would normally not be a kitchen table topic. However, this topic directly reaches home when the breadwinner loses their source of income and thus their way of life is threatened. In addition, when Americans travel abroad and discover that they can no longer enjoy the luxuries that the value of the dollar once provided, the speculation of a threat as it relates to the stature of the U.S. economy emerges.

It is important to make a clear distinction however, as to what actually fuels the speculation toward this second pattern of an impending threat to the U.S. economy. The threat is establish on the basis of another country having an inequitable advantage over the U.S. This was the case with Japan and now China as both countries have been considered currency manipulators and their unfair economic practices blamed as the
cause for the loss of American jobs. During the beginning of the 1980s, then Representative Stephen Solarz alluded to this very point by stating in the Foreign Policy Journal published by the Carnegie Endowment for International Peace that:

"Large deficits may be acceptable in a period of rapid economic growth and full employment. But they become a contentious issue at a time of recession and growing unemployment, especially when there exists a widespread American perception that Japan is not fair in its trading practices."

The U.S. economy during 1980 experienced a severe recession that threatened jobs and the way of life for many Americans. By 1981 the unemployment rate rose above 10 percent, which was a level not experienced since the 1930's. This steep increase in unemployment forced the government to focus on issues such as worker displacement, and company closures and moves.

In order to get a sense of the economic outlook in 1980 in comparison to a more contemporary assessment this case study analyzed the 1981 and 2007 Congressional Budget Office (CBO) Annual Report to Congress on the budget and economic outlook.

1981

The CBO annual report referred to the economic problems faced by the U.S. as a combination of rapid inflation, high unemployment, lagging productivity, and record high interest rates. In addition, as a result of the

---

77 See Solarz, Stephen (1982-83) A Search for Balance pg 76. Stephen Solarz was a Congressman from New York who served as the Chairman of the Subcommittee on Asian and Pacific Affairs of the U.S. House Foreign Affairs Committee.

78 See Krugman, Paul (1999) Morning in Japan
poor performance of the economy, President Reagan proposed several economic remedies to stimulate the economy. 79

2007

The CBO annual report stated that the recent economic slowdown had increased the risk that a recession might occur within the next two years. In addition, some economic indicators were at levels similar to that which preceded recession in the past and significantly weaker growth was expected. Housing sales were expected to fall and as result, slumps in employment and household wealth was expected to turn out worse than what was reported by the CBO. Lastly, despite the fact that unemployment remained solid the previous year, they expected those levels to increase during the earlier half of the year. 80

These two reports represent brief snapshots of the economy during its respective periods. The significant points reflected in both reports are: 1) elevated levels of unemployment, weak growth and productivity, and the looming threat of recession, albeit a recession was already declared by 1981. As mentioned earlier, this was also during similar a period when Japan and China were experiencing an increase in their trade surplus and economic growth, and concerns about currency manipulation were widespread.

80 See Congressional Budget Office (2007) The Budget and Economic Outlook: Fiscal Years 2008-2017. The following year, President Bush signed into law an economic package intended to stimulate the economy
This second pattern of a perceived threat is essentially more prevalent when Americans are able to feel the effects in their pocket books and way of life. However, the threat does not emerge solely due the loss of jobs or slumping economy. As former Congressman Solarz stated in his passage, the American public becomes concerned when they feel as though the U.S. economy is adversely impacted as a result of the unfair economic polices of another country. Some critics have raised the point that due to rising U.S. insecurity with elevated competition, American bashing of China has reached the levels similar to that of Japan in the 1980s. As proof of increased U.S. anxiety toward China, in a recent article in the Pacific citizen, Assistant Editor Lynda Lion points to a 2007 Zogby poll in which eighty-two percent of Americans said they were concerned about purchasing goods from China and over 60 percent of American consumers said they would swear off Chinese goods. As further substantiation, she also highlighted a U.S. based website titled madeintheusa.com. On the website under the “Patriots Page,” you can find statements from Americans such as:

“If you buy American today, your kids will be speaking Mandarin tomorrow.”

Statements such as these speak to the inner beliefs of many Americans that China’s rise is inevitable and it could be a threat to the American way of life. Moreover, when there is a dim U.S. economic outlook akin to 1980 and 2007, a China rise would appear to come at the cost of the American economy.

Americans were concerned about the U.S. economy and therefore, the fear of a threat heightened. However, it is also important to mention that, despite claims of currency manipulation, the U.S. also had concerns with Japan’s protectionist trade

---

81 See Lin, Lynda (2007) Is China the Japan of the 1980s
measures and other policies that placed the U.S. at a disadvantage. In China’s case, there are concerns of China not complying with the laws of the World Trade Organization (WTO)\textsuperscript{82} and a number of other trade related issues that negatively affect the U.S. economy. Therefore, although currency manipulation is not the only issue which fueled U.S. concerns with both countries, it does represent one of the underlying factors that constitutes the basis from which the second pattern of a perceived threat emerged.

Lastly, it is the second pattern that plays a significant role in drawing the attention of policymakers in Congress. This is because the elected officials, who represent those areas disproportionally affected by job displacements and other economic distress, will almost certainly reflect the views of their beleaguered constituents. As the impact reaches an increased number of American families, the result will inevitably amount to an amplified soundboard in Washington that will begin to demand reform. As the next chapter on currency legislation will identify, the coalition of Members of Congress for aggressive action against China has grown as the economic outlook worsened and will continue if the unemployment rate increases.

This second pattern presents the consistent case that most Americans will rightly feel threatened when a developing economy’s economic practices are thought to be unfair and the cause of U.S. economic distress. Currently, this point is playing out as China today faces the intense pressure for currency appreciation equivalent to Japan’s experience in the 1970s and 1980s. Therefore, as with Japan’s experience, until China makes what can be considered dramatic reform, it should be expected that the U.S. will continue to insist that it appreciates the RMB.

\textsuperscript{82} China only recently became a member of the World Trade Organization in November of 2001.
4.5 PARALLELS FOR AN AGGRESSIVE RESPONSE

In order to postulate the type of response needed to address China's currency valuation, this case study identifies the most aggressive U.S. measures taken to pressure Japan to appreciate the yen. In doing so, there are two particular events identified and their effect thoroughly evaluated. The most recent action taken by the U.S. as an attempt to reconcile the discord with China over currency revaluation is also considered in this section of the case study. The purpose of this section in the case study is to enable the reader to understand fully the extent at which certain actions could be economically risky for both countries and the international community.

By 1970, following Japan's significant economic gains after WWII the U.S. was prepared to take steps to force appreciation of the yen. During this time, the U.S. faced increased economic competitiveness from Japan whose currency by this period, was considered extremely undervalued. As a result of the Bretton Woods system and the countries that depended on pegging their currency to the dollar, the U.S. could not devalue the dollar in order to compete with Japan. However, as the second pattern in this case study identifies, the domestic economic pressures and perceived threat from Japan necessitated a response from the U.S. Therefore, President Nixon declared what is commonly referred to as the "Nixon Shock." This resulted in the U.S imposing a 10 percent surcharge across the board for all imports in addition to putting an end to the gold standard where the dollar could be exchanged for gold.83

Figure 4.4 illustrates the fluctuation of the yen following the Nixon Shock in 1971. The unilateral action taken by the U.S., primarily the 10 percent surcharge on imports, placed enormous pressure on Japan whose economy depended on exports to the U.S. Subsequently, the yen appreciated from 360 yen to the dollar to 340 yen and by the end of 1971, it would appreciate to 315 yen.

In December of 1971, following multilateral negotiations between the leading economic powers, the U.S. agreed to devalue the dollar at a rate of 7.89 percent against the value of gold. As a result, other economies were allowed to revalue their currency against the dollar. As such, the yen substantially appreciated to 308 yen to the dollar. The Japanese yen, as shown above, would experience steady appreciation throughout the 1970s, but it began to depreciate against the dollar leading into the 1980s.

---

The second aggressive approach came in 1985 as the U.S. trade deficit with Japan reached unprecedented levels. This approach came following a dramatic increase in the value of the dollar at the beginning of the 1980s. As the effects of "Reaganomics"\(^\text{85}\) commenced, the dollar experienced about an 80 percent appreciation against its major trading partners, which resulted in a deeper U.S.-Japan trade deficit. In response, the U.S. used this opportunity for a multilateral meeting referred to as the Plaza Accord, in which ways to reconcile the massive imbalance that threatened the U.S. economy were at issue.

During the 1985 Plaza Accord, the U.S. was successful in reaching an agreement with the leading G-5 countries to work collectively within the foreign exchange market to reduce the value of the dollar. Given the strength the dollar reached against the other currencies, a depreciation in the value of the dollar was expected to help stabilize the international markets. In addition, there was great anticipation for a reduction in the U.S. trade deficit primarily with Japan. The outcome from the Plaza Accord resulted in a dramatic depreciation of the dollar against the yen from 240 yen to about 120 yen to the dollar. However, Japan never expected such a dramatic spike in the value of the yen and this resulted in extreme economic fluctuation over the next few years.

\(^{85}\) Reaganomics refers to the 1980s when President Reagan, dramatically cut back on domestic spending while also radically lowering taxes.
As figure 4.5 displays, the value of the yen went from 250 to the dollar in 1984 to 122 yen by 1987. This was equivalent to a 50 percent decrease in the value of the dollar, which as expected, resulted in a sizable reduction of the U.S. trade deficit with Japan.\(^{86}\) However, Japan's economy later spiraled out of control and it would experience further difficulty in an attempt to try and correct the effects of these policies.

The "Nixon Shock" and the Plaza Accord agreement offers evidence that the U.S. felt an aggressive response was warranted when Japan both, accumulated a sizable trade surplus with the U.S., and increased its competition with U.S. exports. In each case the U.S. engaged in an aggressive campaign to appreciate the value of the yen-- The Nixon Shock unilaterally at about 35 percent, The Plaza Accord multilaterally at about 70

\(^{86}\) See Kuroda, Haruhiko (2002) Japan in the Global Economy: A Personal View
percent—both of which successful in their endeavor to some extent.\textsuperscript{87} However, while the yen did effectively appreciate, the U.S. trade deficit with Japan never decreased to a complete level. In fact, today the U.S.-Japan trade deficit is still one of the largest behind China whose numbers have totally eclipsed Japan’s. Despite this fact, Japan is no longer considered the major threat to the U.S. economy that it once was. So what happened as a result of the dramatic appreciation and what could be the implications for a sizable appreciation of the RMB? In order to find out we must analyze Japan’s experience during the 1990s.

4.6 EXAMPLES OF IMPLICATIONS FROM JAPAN

Many economists such as David Weinstein and Takatoshi Ito argue that the dramatic appreciation of the yen following the Plaza Accord agreement played a large role in the development of the asset bubble, which plagued Japan’s economy leading into the 1990s.\textsuperscript{88} This is largely due to the fact that the dramatic appreciation of the yen caused great economic uncertainty and fears of deflation which lead officials in Japan to institute monetary polices intended to stimulate the economy. However, these monetary polices proved to be overly excessive and this caused the hyperinflation which resulted in a spike in asset and real estate prices.

The amount of pressure the U.S. placed on Japan to appreciate the yen was viewed by some as disproportionate and excessive. Moreover, following WWII Japan was receptive and willing to work with U.S. recommendations. Albeit, the relationship


between both countries hardened during the 1980s as the U.S. pushed back at Japan's unfair protectionist measures and what was considered to be manipulative currency policies. However, the asset bubble that ensued after the great appreciation of the yen following the Plaza Accord agreement caused Japan to be more resistant toward U.S. proposals. In an article in the Asian times, Hisane Masaki highlights this fact when describing the tense relationship between then U.S. President Bill Clinton and Japanese Premier Morihiro Hosokawa.\footnote{See Masaki, Hisane (2005) China and the Legacy of the Plaza Accord. Asia Times} During a summit in Tokyo in which the U.S. offered a proposal to ease trade and economic tension between both countries, Japan soundly rejected the offer with Primier Morihiro Hosokawa grandly commenting that, “Japan – U.S. relations have become relations between grown-ups.” This brief yet substantive statement summed up the intention of Japan to no longer sit in the back seat and allow the U.S. to drive ahead with its demands and economic proposals.

In the end, the U.S. did not take Japan's rejection lightly and as a result, a trade war between both countries proceeded. The initial blow came when the U.S. retaliated by imposing a 100 percent tariff on all luxury vehicle imports from Japan.\footnote{President Reagan in 1987 imposed a similar 100 percent tariff on some Japanese-made computers, television sets and power tools.} This caused Japan to do what it had never done before against the country that it worked so closely with following WWII. Japan brought before the WTO under Section 301, claims of illegal trading measures by the U.S.\footnote{See Masaki, Hisane (2005) China and the Legacy of the Plaza Accord} Relations with Japan would later cool off from these tumultuous exchanges experienced in the early and mid 1990s. However, despite years of appreciation, in 1997 and 1998 Japan intervened significantly in the market to
reduce dramatically the value of the yen by about 55 percent.\textsuperscript{92} In addition, as mentioned earlier, Japan still currently runs a sizable trade surplus with the U.S. Therefore, this leaves open the question as to whether some of the aggressive approaches to appreciate the yen were actually effective in the long term.

4.6 CONCLUDING THOUGHTS

The parallels presented by Japan’s experience between the 1970s and 1980s present the case that an aggressive pursuit to appreciate the RMB may not be, among other things, the silver bullet that alone reduces the U.S.-China trade deficit. In addition, doing so rather precipitously could run the risk of actually derailing the Chinese economy in the process. This possibility would be neither advantageous nor preferred by the U.S. and the international community, considering that many economies would feel the encumbering force accompanied with a crumpling Chinese economy.

An important side note not mentioned while describing Japan’s economic malaise following the Plaza Accord agreement, but has significant stature in the conclusion of this thesis, is the fact that Japan had a number of other internal economic problems, many of which were exacerbated as appreciation was hastened. It was not until 2001, that the government began to take a more aggressive approach toward boosting Japan’s economy. Japan faced an increasing national debt, a weak economy, and surprisingly high public spending, and the Prime Minister decided to take more of a hard line approach than his predecessors. He literally took on a legislature that had been accustomed to securing pork and unwilling to make tough decisions such as privatizing the post office and welcoming outside invest and competition. Subsequent to his actions toward reducing

\textsuperscript{92} See Burdman, Mary (2003) China Says No to Plaza Accord Pressure
spending and privatizing the state owned bank, post office, and life insurance company, the Prime Minister revitalized the market and liberated $3 trillion in assets. It took these reforms and an aggressive approach over a decade later to make the necessary adjusts for a more stable Japanese economy.

China also has a number of internal economic challenges such as reforming its State Owned Enterprises (SOE), diversifying its labor portfolio, and reducing its strong dependence on foreign investment and trade. In addition, some economists have made mention of the fact that, despite China’s much larger investment rate, its economy is not growing significantly faster than Japan’s during comparable periods. For many, this discrepancy is evidence of a weakness in China’s economy given that it obviously has to divert funds toward unproductive areas that are not beneficial toward growth. With these challenges in mind, hasty appreciation could spark a chain of destabilizing events that, like Japan, could take over a decade to overcome.

China has made it clear that it only intends to allow the RMB to appreciate gradually in fear that hasty action will hurt its economy. To substantiate its claim, Chinese officials have alluded that the textile industry, which accounts for 72 percent of the country’s trade surplus loses 8.2 billion yuan of profits for every percentage point the RMB appreciates. As China continues to initiate reforms, a more gradual approach starkly different from Japan’s experience should prove beneficial for both the U.S. and China. In addition, it could prevent the deterioration of bilateral trade and engagement as experienced with Japan during the 1990s.

93 Moffett, Sebastian (2006) New Blueprint: Koizumi’s Success Charts the Path to Japan’s Future; Forceful Leader Governed Effectively Against Odds; No Going Back to Old Ways; Ally of Bush, Disliked in China
95 See China Daily (2007) Wu: Large yuan appreciation would hurt China