



An Analysis of China Currency Issues Affecting IPC Members

A White Paper by the IPC
Government Relations Committee

Executive Summary

Over the past 15 years as manufacturing in China has increased, so have complaints of various unfair trade practices. One of the persistent issues has been the steady exchange rate for the RMB (yuan) vs. the American dollar, thus providing a currency advantage for Chinese fabricators due to the undervalued RMB. American PWB fabricators, being the major constituents of IPC in the early '90s were just beginning to feel severe competitive price pressure. The IPC Government Relations (GR) committee at the time provided support for the various pieces of legislation that attempted to reduce or eliminate this currency advantage, strongly backed much of this legislation.

In 2005, the Chinese RMB was allowed to adjust slightly and slowly. Initially there was little change but on a cumulative basis, there has been a small but measurable reduction of the level of undervaluation. In spite of the modest movement, Chinese and American government officials continue to disagree on future actions to equilibrate the currencies. Therefore, proposed legislation will, in all probability, be continued to be introduced.

In recent years, the IPC membership demographic has changed with a larger percentage of multinational companies as well as local, non American fabricators and EMS companies becoming members. We now must realize that a significant fraction of IPC's membership would be against supporting punitive measures against China for currency issues.

Other organizations similar to the IPC have faced similar situations and have become ineffective due to lack of a common agenda. The IPC GR committee has therefore decided that at this time, since there is no consensus, to take a neutral stance on China currency.

The balance of this white paper provides a great deal of background, history and data along with present legislative efforts and the legislative outlook. It concludes with justification for the neutral stance that has been adopted on this issue.

Overview

The Chinese government has for years maintained a relatively steady fixed exchange rate for the yuan versus the American dollar. Over the past few years, many American manufacturers have expressed concern that this policy injures their ability to compete effectively in the global marketplace. As a result, several pieces of legislation have been introduced in the U.S. Congress that would take a variety of approaches towards convincing China to allow its currency to trade in an increasingly transparent and market-oriented fashion.

Those industries concerned with Chinese currency manipulation that have chosen to actively lobby the issue are clashing in Washington over which approach deserves their support. Therefore, the National Association of Manufacturers (NAM)-led coalition that formed has been limited to very general statements expressing dissatisfaction with the situation and has had little direct legislative impact. Other industries remain concerned but have chosen against active lobbying given the lack of consensus on how to best address the problem.

Under a floating exchange rate system, the relative demand for the two countries' goods and assets would determine the exchange rate of the yuan to the dollar. As the demand for Chinese exports increases in America, the yuan would appreciate and be commensurately stronger against the dollar. Many economists contend that, for the first several years, the fixed value was likely close to the market value. But in recent years, changing economic conditions make it likely that the yuan would have appreciated had it been market-determined.

The sharp increase in China's foreign exchange reserves (\$403 billion at the end of 2003 grew to \$1.3 trillion by the end of June 2007) and China's large merchandise trade surplus (\$178 billion in 2006) are indicators that the yuan is significantly undervalued. Many observers have noted that a number of China's banks would face insolvency if exposed to rapid appreciation of the yuan, and that as such, the Chinese government has a vested interest in cleaning up bad debts and only allowing slow appreciation while these banks become more stable.

Where a definite relationship exists between increased Chinese imports and the competitiveness of the domestic textile and steel industries, a more complicated relationship exists for the electronics industry. Recently, many electronics manufacturers, representing the entire electronics supply chain, have chosen to locate their plants in Asia.

Recent History

From 1994 until July 2005, China maintained a policy of “pegging” its currency (the renminbi or yuan), to the U.S. dollar at an exchange rate of roughly 8.28 yuan to the dollar. The Chinese central bank maintained this peg largely by buying dollar-denominated assets in exchange for newly printed yuan in order to eliminate excess demand for the yuan. As a result, the exchange rate between the yuan and the dollar basically remained the same despite changing economic factors which could have otherwise caused the yuan to appreciate relative to the dollar.

On July 21, 2005, the Chinese government announced that the yuan's exchange rate would become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket," (it was later announced that the composition of the basket includes the dollar, the yen, the euro, and a few other currencies), and that the exchange rate of the U.S. dollar against the yuan would be immediately adjusted from 8.28 to 8.11, an appreciation of about 2.1 percent. Unlike a true floating exchange rate, the yuan would (according to the Chinese government) be allowed to fluctuate by 0.3 percent on a daily basis against the basket.

Since July 2005, China has allowed the yuan to appreciate steadily, but very slowly. The Chinese government has continued to accumulate foreign reserves at a rapid pace, which suggests that if the yuan were allowed to freely float, it would appreciate much more rapidly. The current situation might be best described as a "managed float," whereby market forces determine the general direction of the yuan's movement, but the government retards its rate of appreciation through market intervention.

U.S. Concerns

U.S. policymakers, business and labor representatives have charged that China's currency is significantly undervalued vis-à-vis the U.S. dollar (even after the recent revaluation), making Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. Further, they argue that the undervalued yuan has contributed to the burgeoning U.S. trade deficit with China (which reached \$233 billion in 2006) while hurting U.S. manufacturing in several sectors that are forced to compete domestically and internationally against "artificially" low-cost goods from China. Additionally, some analysts contend that China's currency policy induces other East Asian countries to intervene in currency markets in order to keep their currencies weak against the dollar in order to compete with Chinese goods.

Critics contend that, while it may have been appropriate for China during the early stages of its economic development to maintain a pegged currency, it should let the yuan freely float today, given the size of the Chinese economy and the impact its policies have on the world economy.

Chinese Concerns

Chinese officials assert that their currency policy is not meant to favor exports over imports, but instead takes an approach many countries employ to foster economic stability through currency stability. They express concern that floating the yuan could spark an economic crisis in China and would especially be damaging to its export industries at a time when painful economic reforms (such as closing down inefficient state-owned enterprises) are being implemented. They further contend that the Chinese banking system is too underdeveloped and burdened with heavy debt to be able to deal effectively with possible speculative pressures that could occur with a fully convertible currency.

Many Chinese government officials look at the troubles that Russia encountered in its rapid shift from a command economy to a market economy and seek ways to mitigate the economic turmoil that inevitably ensues from structural change.

Concerns have also been raised over the effects an appreciating yuan would have on farmers (due to lower-priced imports). Chinese officials view economic stability as critical to sustaining political stability; they fear an appreciated currency could reduce employment and lower incomes in various sectors, and thus cause worker unrest.

Chinese officials have indicated that their long-term goal is to adopt a more flexible exchange rate system and to seek more balanced economic growth through increased domestic consumption and the development of rural areas. However, they want to proceed at a gradual pace to ensure economic stability.

Implications of China's Currency Policy

If the yuan is undervalued vis-à-vis the dollar (estimates range from 15 percent to 40 percent or higher), then Chinese exports to the United States are likely cheaper than they would be if the currency were freely traded, providing a boost to China's export industries (and, to some degree, an indirect subsidy).

Eliminating exchange rate risk through a managed peg also increases the attractiveness of China as a destination for foreign investment. However, an undervalued currency makes imports more expensive, hurting Chinese consumers and Chinese firms that import parts, machinery and raw materials. Such a policy, in effect, benefits Chinese exporting firms (many of which are owned by foreign multinational corporations) at the expense of non-exporting Chinese firms, especially those that rely on imported goods. This may impede the most efficient allocation of resources in the Chinese economy.

Another daunting problem is that the Chinese government must expand the money supply in order to keep purchasing dollars, which has encouraged the banks to adopt easy credit policies, raising the threat of inflation and non-performing loans.

Implications of China's Currency Policy for the U.S. Economy

When exchange rate policy causes the yuan to be less expensive than it would be if it were determined by supply and demand, it causes Chinese exports to be relatively inexpensive and U.S. exports to China to be relatively expensive. As a result, U.S. exports and the production of U.S. goods and services that compete with Chinese imports fall in the short run. (Many of the affected firms are in the manufacturing sector, including members of IPC). This does, however, raise the trade deficit in the short run.

A society's economic health is often measured not by how much it can produce, but how much it can consume. An undervalued yuan that lowers the price of imports from China allows the United States to increase its consumption through an improvement in the terms of trade.

From a long-term perspective, the lasting effect of an undervalued yuan is to increase the purchasing power of U.S. consumers. As this applies to IPC members, it can facilitate greater consumption of electronics which are made, either in whole or part, by IPC member companies. Imports from China are not limited to consumption goods. U.S. producers also import capital equipment, materials, and parts from China. An undervalued yuan lowers the price of these U.S. products and can help increase their market share.

An undervalued yuan also has an effect on U.S. borrowers. When the United States runs a current account deficit with China, an equivalent amount of capital flows from China to the United States (as can be seen in the U.S. balance of payments accounts). This occurs because the Chinese central bank or private Chinese citizens are investing in U.S. assets, which allows more U.S. capital investment in plant and equipment to take place than would otherwise occur. Capital investment increases because the greater demand for U.S. assets puts downward pressure on U.S. interest rates, and firms are now willing to make investments that were previously unprofitable. This increases aggregate spending in the short run, all else equal, and also increases the size of the economy in the long run by increasing the capital stock.

Private firms are not the only beneficiaries of the lower interest rates caused by the capital inflow (trade deficit) from China. Interest-sensitive household spending, on goods such as consumer durables and housing, is also higher than it would be if capital from China did not flow into the United States. In addition, a large proportion of the U.S. assets bought by the Chinese, particularly by the central bank, are U.S. Treasury securities, which fund U.S. federal budget deficits. According to the U.S. Treasury Department, China (as of May 2007) held \$407 billion in U.S. Treasury securities, making China the second largest foreign holder of such securities after Japan.

If the U.S. trade deficit with China were eliminated, Chinese capital would no longer flow into this country, and the government would have to find other buyers of U.S. Treasuries. This would likely increase the government's interest payments. In fact, the Chinese recently were forced to state publicly that they had no intention of a quick sell-off of U.S. Treasuries when rumors roiled the markets.

Net Effect on the U.S. Economy

An undervalued yuan neither increases nor decreases aggregate demand in the United States. Rather, it leads to a compositional shift in U.S. production, away from U.S. exporters and import-competing firms toward the firms that benefit from Chinese capital flows. IPC has members on both sides of this shift. Thus, while it is expected to have no medium or long term effect on aggregate U.S. employment or unemployment, it does impact businesses unevenly.

The gains and losses in employment and production caused by the trade deficit are not dispersed evenly across regions and sectors of the economy: some areas gain while others lose, even within industries. By shifting the composition of U.S. output to a higher capital base, the size of the U.S. economy should be larger in the long run as capital is allocated more efficiently toward America's comparative advantages. The trade deficit with China has not prevented the American economy from registering high rates of growth since 2003.

The United State-China Trade Deficit and the Overall U.S. Trade Deficit

While China is a large trading partner, it accounted for only 15.4 percent of U.S. merchandise imports in 2006 and 26 percent of the sum of all U.S. bilateral trade deficits. Over a span of several years, a country with a floating exchange rate can consistently run an overall trade deficit for only one reason: a domestic imbalance between savings and investment.

Over the past two decades, U.S. saving as a share of gross domestic product (GDP) has been in gradual decline. On the one hand, the United States has high rates of productivity growth and strong economic fundamentals that are conducive to high rates of capital investment. On the other hand, it has a chronically low household saving rate, and recently a negative government saving rate as a result of the budget deficit.

As long as Americans save little, foreigners will use their relatively larger savings to finance investment opportunities in the United States, with a trade deficit as the primary result.

Chinese statistics indicate that more than half of its exports to the world are produced by foreign-invested firms in China, many of which have shifted production to China in order to gain access to low-cost labor. (The returns to capital of U.S.-owned firms in China flow to Americans.) Such firms import raw materials and components (much of which come from East Asia) for assembly in China. As a result, China tends to run trade deficits with East Asian countries and trade surpluses with countries with high consumer demand, such as the United States.

Overall, in 2006, China had a \$55 billion trade deficit with the world excluding the United States. These factors imply that much of the increase in U.S. imports (and hence, the rising trade deficit with China) is largely the result of China becoming a production platform for many foreign companies, rather than unfair Chinese trade policies.

Most Recent Events

In September 2006, President Bush and President Hu agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the "highest official level." China's currency policy was a major topic during the first SED meeting held in December 2006 and the second meeting held in May 2007. The two sides agreed to work to reduce global imbalances through increased savings in the United States and increased domestic consumption and exchange rate flexibility in China. However, China refused to agree to any new major changes to its currency policy. From July 21, 2005, to August 8, 2007, the dollar-yuan exchange rate went from 8.11 to 7.57, an appreciation of about 6.7 percent.

Congressional Action

Many Members of Congress contend that the pace of China's currency reforms and level of the yuan's appreciation against the dollar have been too slow, and some have introduced legislation to put further pressure on the Chinese to speed reforms or to enable U.S. producers to use U.S. trade law to address the impact of China's undervalued currency.

Summaries of major provisions of these bills include:

- H.R. 321 (English) would increase tariffs on imported Chinese goods if the Treasury Department determined that China manipulated its currency, and would require the United States to file a WTO case against China over its currency policy and to work within the WTO to modify and clarify rules regarding currency manipulation.

- H.R. 1002 (Spratt) would impose 27.5 percent in additional tariffs on Chinese goods unless the President certifies that China is no longer manipulating its currency.

- S. 364 (Rockefeller) would apply U.S. countervailing laws (dealing with government subsidies) to products imported from non-market economies (such as China), and would make currency manipulation actionable under this measure.

- H.R. 782 (Tim Ryan) and S. 796 (Bunning) would make exchange rate "misalignment" actionable under U.S. countervailing duty laws, require the Treasury Department to determine whether a currency is misaligned in its semi-annual reports to Congress on exchange rates, prohibit the Department of Defense from purchasing certain products imported from China if it is determined that China's currency misalignment has disrupted U.S. defense industries, and would include currency misalignment as a factor in determining safeguard measures on imports of Chinese products that cause market disruption.

- H.R. 2942 (Tim Ryan) would apply countervailing laws to non-market economies, make an undervalued currency a factor in determining antidumping duties, requires the Treasury Department to identify fundamentally misaligned currencies and to list those meeting the criteria for priority action. If consultations fail to resolve the currency issues, the USTR would be required to take action in the WTO.

- S. 1607 (Baucus) would require the Treasury Department to identify currencies that are fundamentally misaligned and to designate such currencies for "priority action" under certain circumstances. Such action would include factoring currency undervaluation in U.S. anti-dumping cases, banning federal procurement of products or services from the designated country, and filing a case against in the WTO.

- S. 1677 (Dodd) requires the Treasury Department to identify countries that manipulate their currencies regardless of their intent and to submit an action plan for ending the manipulation, and gives Treasury the authority to file a case in the WTO.

Legislative Outlook

The coalition formed in Washington to lobby for market-oriented reforms to the yuan has great difficulty in forming coherent positions on individual pieces of legislation. For every industry like the steel and textile industries that are at a greater disadvantage due to direct competition with Chinese imports and exports that range between lackluster and non-existent, there are other industries, like printed boards and electronics manufacturing, that have greater global integration and uneven impacts from currency manipulation. These

industries have members who benefit from the increased ability of Chinese firms to buy components for inclusion in consumer and industrial goods destined for American consumers, and also have members with less export-oriented business models that face greater competition from Chinese firms.

As Congress enters a Presidential election year, it is expected that it will continue to lobby the Chinese government for its slow action on currency valuation. However, the lack of an effective lobby on the issue means that the individual bills have little momentum and that a coherent legislative package is unlikely to gain traction. Further, there are strong WTO concerns with most of the legislative remedies that almost certainly will garner a Presidential veto in the unlikely event that any make it through the legislative process.

Instead, these bills are serving to prod the Administration to continue high-level dialogue and prod the Chinese government by allowing the Administration to play "good cop" compared to the "bad cop" image that more severe Congressional policy proposals have fostered.

If IPC became involved in the Chinese currency issue, it would likely split the membership in much the same way that the NAM-led coalition has found itself unable to agree on appropriate legislative remedies. This bifurcation limits the effectiveness of all industries that have chosen to activate their membership on the matter. The effect on IPC would be a significant expenditure of effort and money without net gain for its membership.

Given the likely division of the IPC membership on both the complexities of the issue itself and also with regard to what appropriate remedies would consist of, IPC is best served to avoid a divisive internal debate on the issue that best case scenario could result in limited impact in the legislative process. Instead, IPC can help continue the pressure on the Administration, (and indirectly on China), through a calculated and sustained media campaign and other activities as deemed necessary that would highlight the organization's policy positions on international trade and the impact of international economic forces upon its membership.