CLOSING CASE

China's Managed Float

In 1994, China pegged the value of its currency, the yuan, to the U.S. dollar at an exchange rate of $1 = 8.28 yuan. For the next 11 years, the value of the yuan moved in lockstep with the value of the U.S. dollar against other currencies. By early 2005, however, pressure was building for China to alter its exchange rate policy and let the yuan float freely against the dollar.

Underlying this pressure were claims that after years of rapid economic growth and foreign capital inflows, the pegged exchange rate undervalued the yuan by as much as 40 percent. In turn, the cheap yuan was helping to fuel a boom in Chinese exports to the West, particularly the United States, where the trade deficit with China expanded to a record $160 billion in 2004. Job losses among American manufacturing companies created political pressures in the United States for the government to push the Chinese to let the yuan float freely against the dollar. American manufacturers complained that they could not compete against "artificially cheap" Chinese imports. In early 2005, Senators Charles Schumer and Lindsay Graham tried to get the Senate to impose a 27.5 percent tariff on imports from China unless the Chinese agreed to revalue its currency against the U.S. dollar. Although the move was defeated, Schumer and Graham vowed to revisit the issue. For its part, the Bush administration pressured China from 2003 onwards, urging the government to adopt a more flexible exchange rate policy.

Keeping the yuan pegged to the dollar was also becoming increasingly problematic for the Chinese. The trade surplus with the United States, coupled with strong inflows of foreign investment, led to a surge of dollars into China. To maintain the exchange rate, the Chinese central bank regularly purchased dollars from commercial banks, issuing them yuan at the official exchange rate. As a result, by mid 2005 China's foreign exchange reserves had risen to more than $700 billion. They were forecast to hit $1 trillion by the end of 2006. The Chinese were reportedly buying some $15 billion each month in an attempt to maintain the dollar/yuan exchange rate. When the Chinese central bank issues yuan to mop up excess dollars, the authorities are in effect expanding the domestic money supply. The Chinese banking system is now awash with money and there is growing concern that excessive lending could create a financial bubble and a surge in price inflation, which might destabilize the economy.

On July 25, 2005, the Chinese finally bowed to the pressure. The government announced that it would abandon the peg against the dollar in favor of a "link" to a basket of currencies, which included the euro, yen, and U.S. dollar. Simultaneously, the government announced that it would revalue the yuan against the U.S. dollar by 2.1 percent, and allow that value to move by 0.3 percent a day. The yuan was allowed to move by 1.5 percent a day against other currencies.

Many American observers and politicians thought that the Chinese move was too limited. They called for the Chinese to relax further their control over the dollar/yuan exchange rate. The Chinese resisted. By 2006, pressure was increasing on the Chinese to take action. With the U.S. trade deficit with China hitting a new record of $202 billion in 2005, Senators Schumer and Graham once more crafted a Senate bill that would place a 27.5 percent tariff on Chinese imports unless the Chinese allowed the yuan to depreciate further against the dollar. The Chinese responded by inviting the senators to China, and convincing them, for now at least, that the country will move progressively towards a more flexible exchange rate policy.[34]

Case Discussion Questions

1. Why do you think the Chinese government originally pegged the value of the yuan against the U.S. dollar? What were the benefits of doing this for China? What were the costs?
2. Over the last decade, many foreign firms have invested in China and used their Chinese factories to produce goods for export. If the yuan is allowed to float freely against the U.S. dollar on the foreign exchange markets and appreciates in value, how might this affect the fortunes of those enterprises?
3. How might a decision to let the yuan float freely affect future foreign direct investment flows into China?
4. Under what circumstances might a decision to let the yuan float freely destabilize the Chinese economy? What might the global implications of this be?
5. Do you think the U.S. government should push the Chinese to let the yuan float freely? Why?
6. What do you think the Chinese government should do? Let the yuan float, maintain the peg, or change the peg in some way?