Committee on Ways and Means

China's Currency: The Yuan

- China's currency, the yuan, is a fixed-exchange currency, pegged at 8.28 yuan = $1 US. Despite changes in prices and different growth rates in each country, the yuan-dollar exchange has remained constant since 1994. Meanwhile, the dollar continues to depreciate most notably against the euro.

- There is a consensus among economists and the position of the Administration is that a freely floating, market determined, exchange rate is the best sustainable policy for any major trading economy.

  - CRS has noted, "*The primary lesson of the 1990s seems to be that fixed exchange rate regimes are prone to crisis, while crisis is extremely improbable under floating regimes.*"

  - The IMF recently noted, "*The IMF has for some time believed that it would be in China's best interests to move gradually toward a more flexible exchange rate system.*"

  - However, economists debate the best timing and route for a country to achieve a free exchange. A balanced policy that weighs the risks of too rapid a change in currency policy (and domestic risks for the Chinese economy) against the concerns of not embracing a market-based exchange is the most prudent approach.

- If the yuan is undervalued, there will be two major consequences for international trade: Chinese will import goods at higher price levels and export goods at lower price levels to non-Chinese consumers. Thus, an undervalued yuan would make Chinese exports to the United States less expensive and U.S. exports to China more expensive.

- While the effect differs among various Chinese exports, economists estimate that due to different levels of value-added in China to Chinese exports, a 20 percent revaluation of the yuan, for example, would increase prices on Chinese exports to the United States by just four percent.

- To the extent there is a price effect from a revaluation of the yuan, the higher cost of goods would negatively affect U.S. consumers of Chinese imports and U.S. manufacturers that depend on Chinese imports as inputs into their production.

- Transitioning from a fixed exchange rate to a floating exchange may entail certain risks for China's economy due to the insolvency of the Chinese banking system. An immediate and significant revaluation of the yuan or rapid progression to a float could create a Chinese banking crisis and the yuan could <u>depreciate</u>.

- In order to assist China's transition to a flexible exchange rate regime, the U.S. Department of the Treasury has appointed a senior financial expert to serve as the Secretary's emissary to Beijing. Additionally, as a result partly of pressure from its major trading partners, China has recently taken steps to prepare for a flexible exchange rate regime, including liberalizing its foreign direct investment (FDI) outflows.