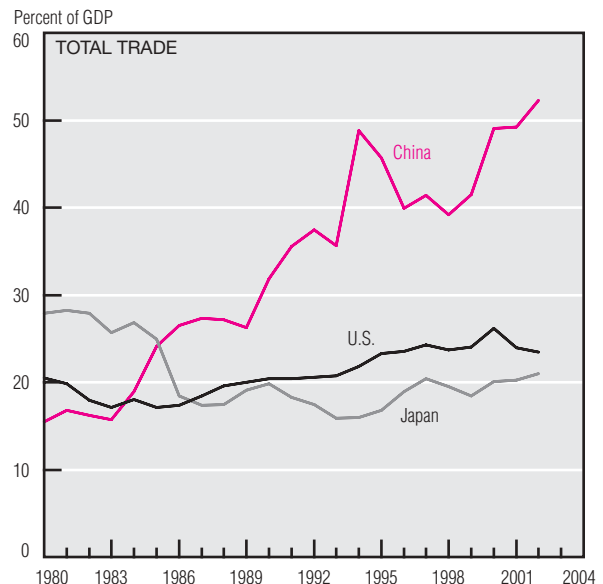
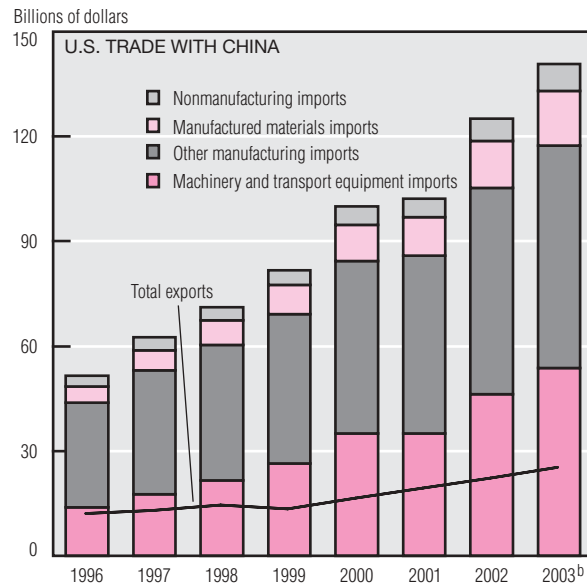
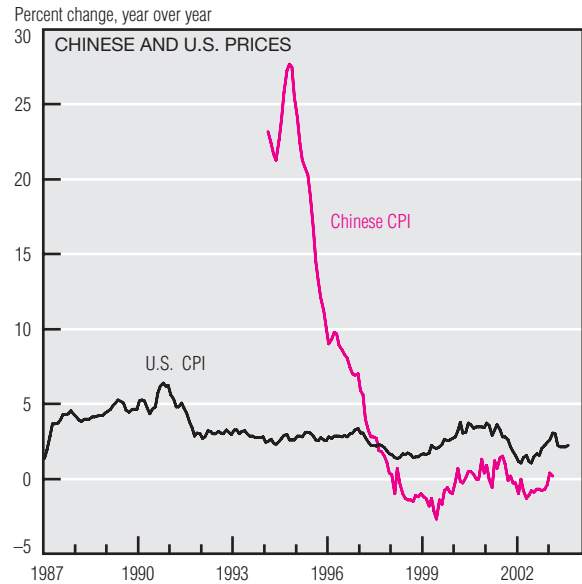
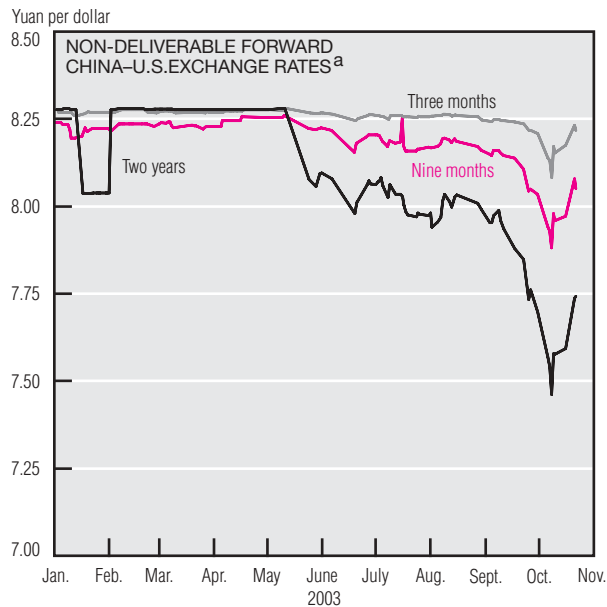


China's Trade



a. A rise indicates a depreciation of the renminbi. (China's currency is the renminbi and its currency unit is the yuan. A renminbi consists of one yuan).

b. Annualized by multiplying the total for the first eight months of the year by 1.5.

SOURCES: U.S. Department of Commerce, Bureau of the Census; International Monetary Fund, *International Financial Statistics*; World Bank Group, *World Development Indicators Online*; and William Testa, "Midwest Manufacturing and Trade with China," *Federal Reserve Bank of Chicago, Chicago Fed Letter*, no. 196, November 2003.

There have been many calls for China to stop pegging the yuan-dollar exchange rate in a narrow range around 8.28. Chinese officials have indicated that they will continue to maintain the exchange-rate peg, but will loosen it sometime in the future. Forward yuan-dollar exchange rates are consistent with this: The three-month forward rate recently climbed back close to the pegged rate, and the two-year forward rate is now pricing in a 6.5% decline in the renminbi relative to the dollar.

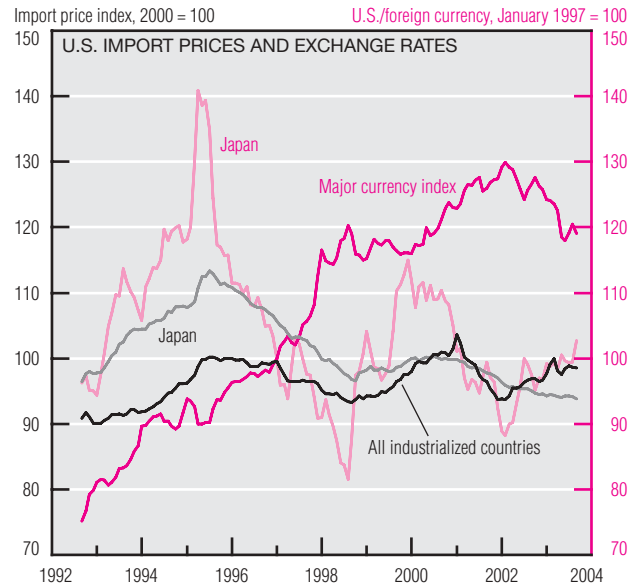
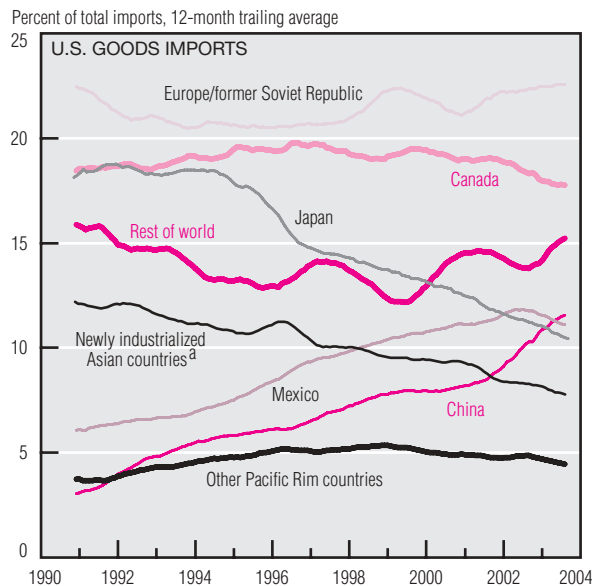
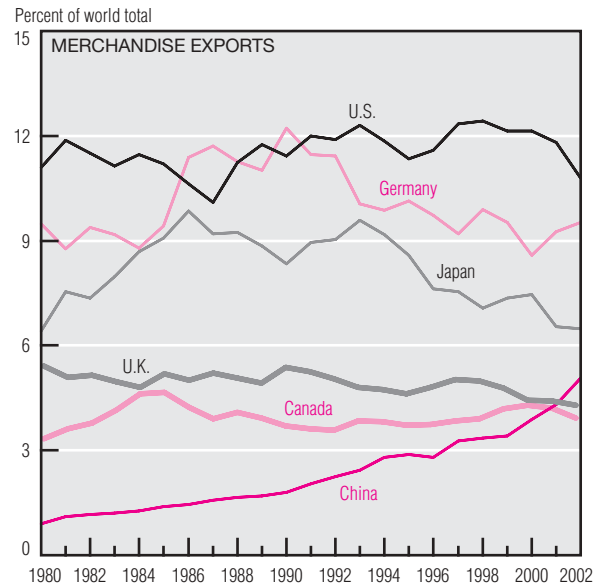
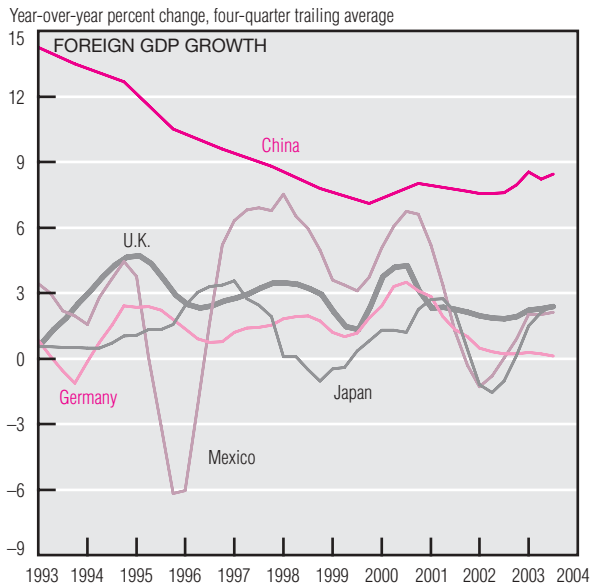
Why is China being urged to let its currency float? The renminbi is widely considered to be undervalued against

the dollar, so that low-priced Chinese exports are hurting domestic manufacturers. Economists typically look at real exchange rates to assess trading advantages. Since the yuan-dollar exchange rate is pegged, real exchange rate changes between the U.S. and China are determined entirely by their differences in inflation. Since U.S. inflation has exceeded Chinese inflation by 2.7% on average since 1998, U.S. imports from China should be getting slightly less expensive relative to domestically produced goods.

Despite these minor changes in recent years, the value of this year's Chinese imports to the U.S. will be

nearly twice as big as in 1998, with most of the increase coming from manufacturing. A recent study showed that China's manufacturing import penetration in the U.S.—the ratio of Chinese imports to the domestic manufacturing market—rose from 1.7% in 1997 to 2.7% in 2001. This import surge, apparently without any large change in the terms of trade between China and the U.S., is not surprising in view of some fundamental changes in the Chinese economy. Export-led industrialization, starting roughly with the rise of Deng Xiaoping in December 1978, has helped turn
(continued on next page)

China's Trade (cont.)



a. Hong Kong, Singapore, South Korea, and Taiwan.

SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, G.5; International Monetary Fund, *International Financial Statistics*; and World Trade Organization.

China into a major economic power. Since 1980, its total trade as a share of its GDP has more than tripled—to slightly over 50%. Since 1991, its real GDP growth has exceeded 6% annually. With the combined effects of robust economic growth and a transition toward more foreign trade, China's exports to the rest of the world have boomed. In fact, from 1996 to 2002, China's share of world merchandise exports increased 81%, which is more than the 60% increase in its share of U.S. goods imports. It is uncertain how much this surge in U.S. imports from China has displaced domestic manufacturing. To a large

extent, Chinese imports to the U.S. have probably displaced imports from other countries. For example, the import shares of Japan and the newly industrialized Asian countries have been falling since the 1990s; Mexico's share of imports to the U.S. has been falling since about 2002.

China probably has displaced some domestic manufacturing, but the role of import prices and exchange rates in this displacement is not entirely clear. For example, from 1995 to 1999, prices for Japan's imports to the U.S. fell more dramatically than prices from other industrialized countries, but the U.S. share of Japanese imports continued

to drop. Furthermore, even if the renminbi appreciated against the dollar, it is unclear how much it would affect Chinese import prices. Exchange rate changes are not always passed through to changes in import prices, as the case of Japan illustrates. Research has shown that roughly 50% of exchange rate changes were passed through to import price changes in the 1980s but only 25% were passed through in the 1990s. One reason import prices do not respond to exchange rate changes is that some exporters try to maintain volume by accepting lower profits when their currency appreciates relative to the dollar.