During the 12 months ending in November 2004, the U.S. registered a $157.6 billion deficit in goods trade with China, a shortfall that accounts for nearly 25% of the total U.S. trade deficit. In recent years, China generally has run a current account surplus equal to approximately 3% of its GDP and has experienced direct investment inflows of a similar magnitude. Contrary to the claims of many analysts, China’s exchange rate policies do not seem to explain much of its trade performance.

In 1995, China pegged its currency, the renminbi, to the U.S. dollar at approximately Rmb 8.3 per dollar. This peg, however, tells us nothing about China’s competitiveness relative to the U.S. because it ignores price patterns. The real renminbi–dollar exchange rate adjusts the exchange rate peg for changes in relative inflation rates, thereby providing a clearer picture of China’s competitiveness.

On a real basis, the dollar has appreciated 2.5% against the renminbi since the beginning of the peg; that movement cannot confer much of a trade advantage on China. The real exchange rate has, however, undergone some large swings. Between June 1995 and October 1997, the dollar depreciated 11.4% against the renminbi because China’s inflation rate exceeded that of the U.S. Between October 1997 and October 2003, however, the dollar appreciated 17.3% against the renminbi on a real basis because China’s inflation rate was lower than that of the U.S. Since October 2003, China’s inflation rate has generally exceeded ours, and the dollar has again depreciated 1.4% against the renminbi on a real basis.

To keep the renminbi pegged at Rmb 8.3 per dollar in the face of an overall balance-of-payments surplus,
the People’s Bank of China, the country’s central bank, buys dollars on the foreign exchange market. The process expands China’s monetary base and risks generating inflation. In fact, this mechanism will prevent China from realizing a long-term trade advantage from its peg, because a rising inflation rate will dull China’s competitive edge.

The People’s Bank of China can frustrate the impact of its dollar acquisitions on its monetary base and inflation by selling domestic assets from its portfolio or by increasing nonmonetary liabilities on its balance sheet, but since the inception of the peg in 1995, the bank has generally not done so. Between 1995:IIQ and 2004:IIIQ, China’s central bank acquired the equivalent of Rmb 3.4 trillion in foreign exchange, and its monetary base grew nearly Rmb 4 trillion.

Since the end of 2000, however, the picture has changed. The People’s Bank has acquired nearly Rmb 2.4 trillion in foreign assets, but the monetary base has grown only Rmb 1.9 trillion. The bank has offset the effect of reserve growth on its monetary base by reducing its holdings of domestic assets slightly and by increasing other, nonmonetary liabilities on its balance sheet. Overall, since 2000, the bank has neutralized 20% of the increase in its foreign reserves. It has also raised reserve requirements, another anti-inflation measure, and the government has tried to slow investment spending.

To be sure, China has many artificial barriers to trade and financial flows that help it sustain an overall balance-of-payments surplus, but the contribution of its exchange rate policies seems to have been overstated.