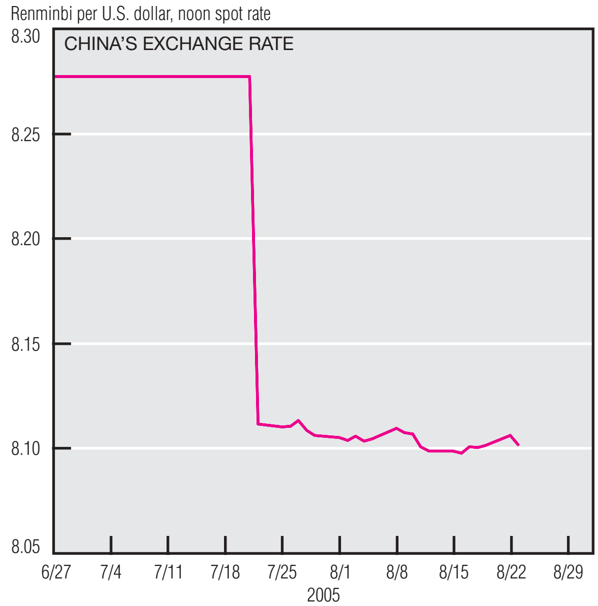
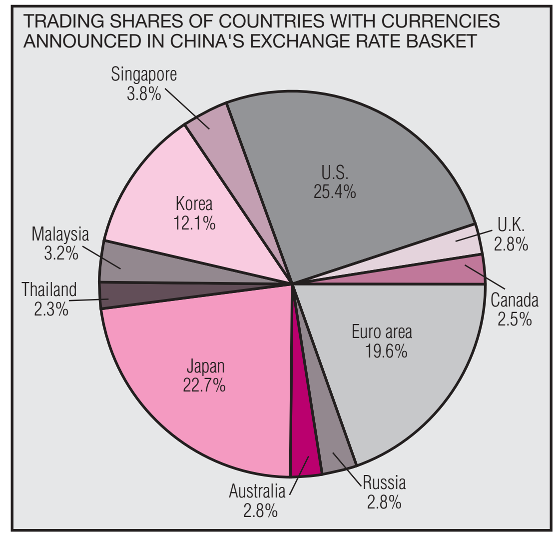
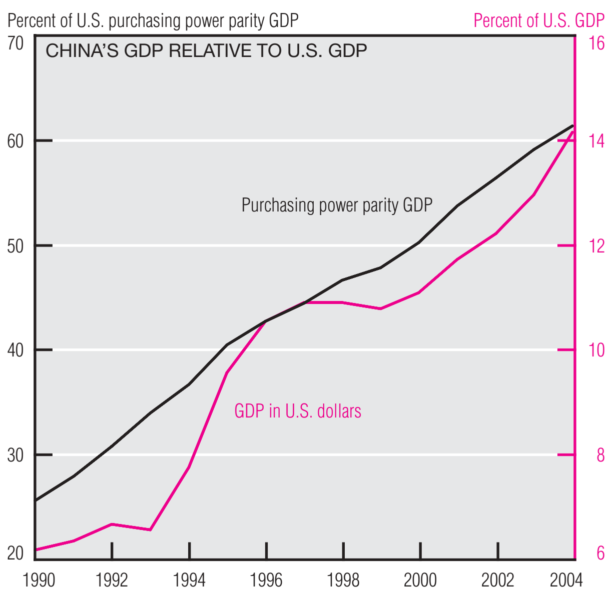
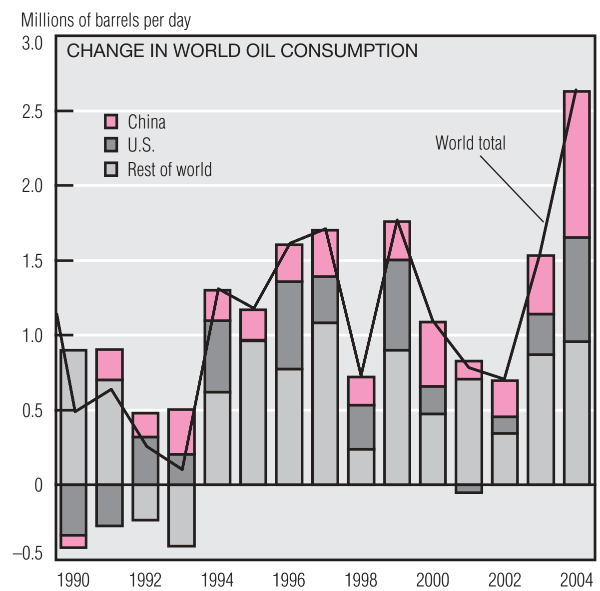
China's Trade, the Dollar, and the Renminbi









SOURCES: U.S. Department of Energy, Energy Information Administration; Board of Governors of the Federal Reserve System; International Monetary Fund, "Direction of Trade Statistics;" and the World Bank.

On July 21, China ended its 10-year policy of pegging the renminbi against the U.S. dollar and announced that it will use a basket of currencies to guide its exchange rate. On August 10, China's Central Bank Governor Zhou Xiaochuan said that trade shares are the "fundamental considerations in the selection of the basket currencies and the weights assigned." Referring to this criterion, he announced the 11 currencies in the basket, four of which—the dollar, euro, yen, and Korean won—are designated as "major currencies." Other considerations for basket weighting and composition include the currency structure of China's debt and sources of foreign direct investment.

After the policy change was announced, the dollar declined 2% against the renminbi. Many analysts do not think this will have a significant impact on the U.S. trade deficit, but some believe a larger decline could. The broader issue is how China affects the U.S. and world economies in general. Assessing its impact is difficult, partly because the size of China's economy is sensitive to the valuation method. In 2004 China's GDP in dollars, at 14% of U.S. GDP, was the seventh largest in the world. This measure had risen sharply in 1995, when China revalued the renminbi–dollar exchange rate. Using the World Bank's purchasing power parity GDP, which values goods and services at the same prices across countries, China's GDP, at over 60% of U.S. purchasing power parity, was the world's second largest in 2004.

In some ways, China's influence in the U.S. and world economies is less ambiguous. Although China accounted for only 7% of oil consumption in 2003, it was responsible for 37% of oil consumption growth in 2004 (1.0 out of 2.6 million barrels per day),

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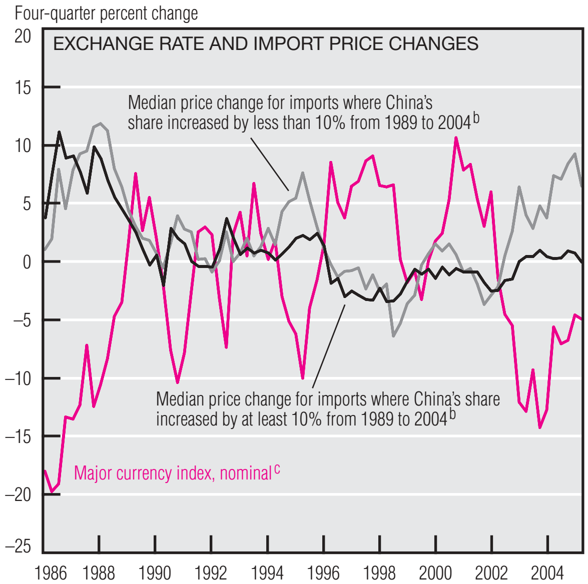
China's Trade, the Dollar, and the Renminbi *(cont.)*



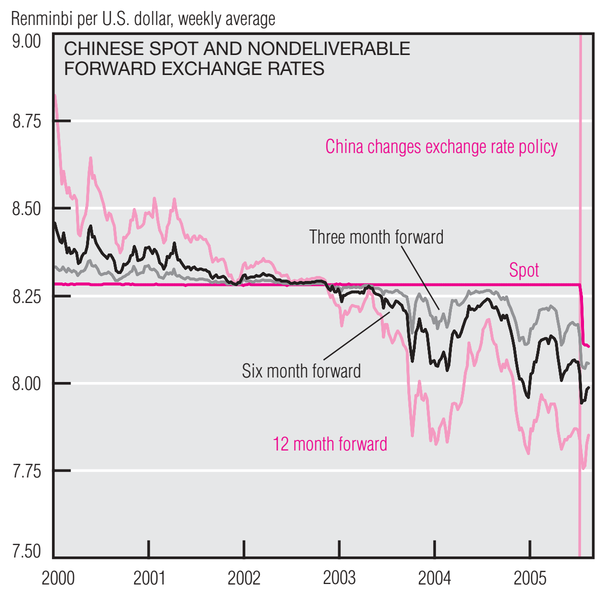
China's Economic Growth and External Accounts

China's Real Economic Growth (percent change)

	2002	2003	2004	2005[d]
GDP	8.0	9.3	9.5	9.0
Consumption	7.4	6.1	6.4	6.5
Gross capital formation	13.2	19.1	14.3	11.7
Fixed capital formation	14.1	19.9	16.8	13.5
Exports	29.4	26.8	28.4	23.0
Imports	28.2	24.4	22.9	12.0

China's External Account (billions of dollars)

	2002	2003	2004	2005[d]
Current account balance	35	46	72	102
Capital account balance	32	71	135	118
Change in foreign exchange reserves	76	117	206	220
Foreign exchange reserves	286	403	610	830



a. Shares are calculated over the most recent 12-month period.
b. Three-digit end-use categories.
c. Trade weighted exchange rate of dollar against major currencies.
d. World Bank forecast.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Bureau of the Census; U.S. International Trade Commission; Board of Governors of the Federal Reserve System; "Exchange Rate Pass-through to U.S. Import Prices: Some New Evidence," April 2005; World Bank, *China Quarterly Update*, August 2005; and Bloomberg Financial Information Services.

making it that year's largest contributor to this growth.

The share of U.S. imports coming from China jumped from 2.5% in 1989 to 14.0% in the 12 months ending June 2005. As long as China pegged the renminbi, its local currency price of exports to the U.S. did not fluctuate with the dollar. Thus, one might think that for the import categories in which China's share grew most dramatically, import prices may be less responsive to declines in the dollar than in the 1980s. Since the dollar began declining in 2002, prices have been relatively flat for imports in which China's share grew more than 10 percentage points since 1989; for other imports they have been increasing. When the dollar declined in the late 1980s, the two import categories had similar patterns of increase.

The World Bank forecasts that China's current account surplus will increase from $72 billion in 2004 to $102 billion by the end of 2005, largely because they expect China's import growth to decline more than its export growth. China also runs a capital account surplus. It exactly offsets these surpluses by accumulating foreign exchange reserves, some of which are dollar-denominated. If the renminbi were to appreciate against the dollar, the value of these reserves would fall. Nevertheless, for the renminbi–dollar exchange rate, nondeliverable forward rates remain below the spot rate, suggesting that some expect the renminbi to strengthen further against the dollar.