China's Pegged Exchange Rate and Its Political Economy

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On April 3, 2010, China's deputy minister of commerce echoed what Premier Wen Jiabao stated in March: "the Chinese currency, renminbi, is not undervalued."[1] Both Premier Wen and Deputy Minister Chen used the ongoing bilateral trade statistics to demonstrate this point. Premier Wen went further to say that a stable renminbi has contributed to the global recovery from the financial crisis and the current exchange rate is reasonable and beneficial to both the Chinese people and the world.[2] The Chinese used a "pressure test report" to support these arguments. This report was released during a labor-intensive industry meeting, and indicated that a 3 percent appreciation of the renminbi would reduce 30–50 percent of profit for industries such as home appliances, cars, and cell-phones. Many other industries would suffer even further losses.[3]

The Obama administration took immediate action, paradoxically by delaying its own Chinese currency report scheduled to be released that same day. As Sewell Chan from the *New York Times* suggested, this was a signal to China that the United States intended to avoid conflicts and was still willing to resolve the exchange rate issue through diplomatic means. In the

[1] Feifei Qin, "Shangwubu Fu Buzhang Cheng Renminbi Huilu Wei Bei Digu, Wu Shuosandaosi," *Sohu Financials* (April 3, 2010), http://business.sohu.com/20100403/n271294426.shtml.
[2] Jiabao Wen, "Renminbi de Bizhi Meiyou Digu, Jiang Baochi Jiben Wending," *China News Network* (March 14, 2010), http://business.sohu.com/20100314/n270806613.shtml.
[3] "Duoge hangye renminbi yali ceshi jieguo bu leguan," *Jinji Cankao Bao* (April 2, 2010), http://business.sohu.com/20100402/n271273471.shtml.

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meantime, the U.S. Treasury Secretary Timothy Geithner tried to pressure China into reconsidering its pegged exchange rate.[4]

Such U.S.-China interactions regarding the value of the renminbi are not new. President Obama's first visit to China last November was under careful scrutiny by many analysts and researchers. One of the major concerns Obama raised was the undervalued Chinese currency: the renminbi. Unfortunately, Obama was unable to get much response from Chinese policymakers. Less than two weeks later, a group of European officials tried to persuade Beijing to begin strengthening its currency during an EU-China summit in Nanjing on November 30, but did not make much more progress than President Obama.[5] Ostensibly, these cases demonstrate only a routine rejection from the Chinese side after several years of pegging to the U.S. dollar, yet there are actually many contextual reasons behind this decision.

Economists Barry Eichengreen and Ricardo Hausmann refer to countries without their own capital markets as facing the "original sin" of dependence on foreign currency borrowing, which tends to increase vulnerability to crises by creating a dangerous mismatch between liabilities in a foreign currency and assets in domestic currency.[6] Although China has developed an incipient form of capital market, its pegged exchange rate stands in the way of further development of the capital market.

Similarly, Eswar Prasad argues that currency flexibility is an essential prerequisite for low inflation and stable growth, rather than simply an objective in itself.[7] Based on that logic, giving the Chinese central bank room to raise or lower interest rates by freeing it from having to target a particular exchange rate would help rein in credit growth and deter reckless investment, reducing the risk of boom-bust cycles. Henry Paulson asserts that currency appreciation and greater flexibility in China's exchange rate could limit the impact of rising world oil and commodity prices on prices in China while at the same time allowing Chinese monetary policy to be a more effective tool for ensuring stable growth.[8]

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[4] Sewell Chan, "U.S. to Delay Chinese Currency Report," *New York Times* (April 3, 2010), http://www.nytimes.com/2010/04/04/business/04yuan.html.
[5] Patti Waldmeir, "Rebuff for EU in push for strong renminbi," *Financial Times* (London: Nov 30 2009), 4.
[6] Harold James, "The Making of a Mess: Who Broke Global Finance, and Who Should Pay for It?" *Foreign Affairs* 88, no. 1 (New York: Jan/Feb 2009): 165.
[7] Eswar Prasad, "Effects of the Financial Crisis on the U.S.-China Economic Relationship," *Cato Journal* 29, no. 2 (Washington, DC: Spring 2009): 227.
[8] Henry Paulson, "A Strategic Economic Engagement: Strengthening U.S.-Chinese Ties," *Foreign Affairs* 87, no. 5 (New York: Sept/Oct 2008): 62.

The reality of the Chinese exchange rate is troublesome. An IMF study by Steven Dunaway and Xiangming Li maintains that estimates of renminbi undervaluation range from zero to nearly 50 percent.[9] William Cline and John Williamson survey many existing estimates of the equilibrium value of the renminbi and find that the literature offers widely varying answers. However, only one of the eighteen studies in their survey concludes that the renminbi is overvalued.[10]

There are many disadvantages to China’s pegged exchange rate policy and multiple forces that try to push it upward for various purposes. However, despite a monitored float between 2005 and 2008, the renminbi repegged again in 2008 and has not moved significantly since then. Eichengreen explains that since around 60 percent of China’s official reserves are held in dollar-denominated assets (Yoshikuni goes further to say it is around 70–80 percent[11]), China is trapped by the magnitude of its current dollar holdings. The government has no choice but to peg its currency.[12] Although this is a possibility, in this paper, we are going to assume that China has a choice in its foreign exchange policy and chooses to peg on its own accord. I will demonstrate that economic reasons alone are not sufficient to explain China’s exchange rate policy. Instead, a combination of economic, political, philosophical, and strategic motivations inspire the renminbi’s continued pegging to the U.S. dollar.

Economic Explanations

One common argument explaining China’s current exchange rate policy is that China is dependent on its export industry. Hofman and Kuijs argue that by 2006 Chinese government spending and personal consumption combined for only half of China’s GDP, one of the lowest shares of any economy in the world — in 2006, personal consumption accounted for only 36 percent of GDP, yet net exports jumped from $50 billion (2.5 percent of GDP) to $300 billion (9 percent of GDP.[13] Thus, China’s GDP growth is more export driven

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[9] Morris Goldstein and Nicholas R. Lardy, “China’s Exchange Rate Policy: An Overview of Some Key Issues,” Debating China’s Exchange Rate Policy. Peterson Institute for International Economics (Washington, DC: 2008), 17.
[10] William R. Cline and John Williamson, “Estimates of the Equilibrium Exchange Rate of the Renminbi: Is There a Consensus and, If Not, Why Not?” Debating China’s Exchange Rate Policy. Peterson Institute for International Economics (Washington, DC: 2008), 131.
[11] Shinichi Yoshikuni, “Asia as a financial centre — Opportunities and obstacles,” *Journal of Asset Management* 9, no. 2 (London: July 2008): 81.
[12] Barry Eichengreen, “The Dollar Dilemma: The World’s Top Currency Faces Competition,” *Foreign Affairs* 88, no. 5 (New York: Sept/Oct 2009): 56.
[13] Bert Hofman and Louis Kuijs, “Rebalancing China’s Growth,” Debating China’s Exchange Rate Policy. Peterson Institute for International Economics (Washington, DC: 2008), 109–121.

rather than consumption driven. Therefore, a steady — or even fixed — exchange rate is essential to reduce risk for the export sectors.[14] On the other hand, Calbreath demonstrates that the cost of production has increased in China from 50 percent lower than the U.S., to only five percent.[15] Under this assumption, renminbi appreciation will cause U.S. businesses to start producing goods domestically or to outsource their production elsewhere.

However, Goldstein and Lardy point out that while an appreciation of renminbi might make exports more expensive, it will also lower the cost of imported inputs, thereby moderating the overall increase in export prices.[16] Empirical evidence suggests that even when China's exchange rate exhibited a large real appreciation (30 percent) between 1994 and 2001, its economic growth never dropped below 7.5 percent.[17] This indicates that renminbi appreciation, even in China's export-driven economy, did not seriously affect China's overall economic growth. Why should China sacrifice monetary independence when the alternative is acceptable? Thus, it seems that pegging the renminbi simply because of export dependency is an insufficient explanation.

Another economic explanation is that by keeping the renminbi pegged, China would accumulate more foreign currency reserves, and having more reserves is a positive economic factor. According to Chin, China has increasingly promoted investments by Chinese banks, firms, and official agencies in companies and commercial projects around the world. The investments in Africa, for example, have brought international attention. Through these high-risk but high-return investments, China was able to make a substantial profit.[18] However, because China needs to pay higher interest domestically for the sterilization in order to sell bonds, it is losing a significant amount of revenue that could be made through renminbi appreciation. In addition, the higher returns it currently receives from its investments may not be sustainable because the investments are so risky.

Several additional economic explanations argue that conditions are favorable for China to peg its currency, and the consequences facing it are relatively few. Dorn suggests that nearly all banks and non-bank financial institutions are state-owned and controlled. Even in many supposedly

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[14]Lawrence J. Broz and Jeffry A. Frieden, "The Political Economy of International Monetary Relations" *Annual Review of Political Science* 4, no. 1 (2001): 323.
[15] Dean Calbreath, "Made in China," *Network Journal* 16, no. 1 (New York: Oct 2008): 48.
[16] Goldstein and Lardy 2008, 20–22.
[17] Ibid.
[18] Gregory Chin, "China as a Creditor: A Rising Financial Power?" *Journal of International Affairs* 62, no. 1 (New York: Fall 2008): 88–92.

"privatized entities," private investors can only take a minority position.[19] Capital controls allow the central bank to peg the exchange rate while at the same time successfully sterilizing capital inflows to prevent inflation. However, Anderson points out that this market socialism or "financial repression" is going to pose a long-run risk for future development.[20] Even though the suppressed inflation seems to be stable, capital may flee China and the boom could turn into crisis when the bottled-up liquidity eventually surfaces.[21]

Basic economic theory grants evidence to the assertions above. Government intervention in the foreign exchange market usually involves the following steps. A country that wishes to prevent its exchange rate from appreciating enters the foreign exchange market to buy dollars in exchange for its domestic currency. At the same time, it sells an equivalent volume of treasury bills to prevent any net addition to the money supply. A world without capital mobility, as Williamson argues, would enable the central bank to simultaneously control the money supply and the exchange rate. However, in order to continue selling treasury bills the central bank must increase the interest rate. Thus, a world with a high degree of capital mobility will attract a further capital inflow.[22]

One explanation is that the Chinese government still allows limited capital mobility and that capital inflow is under careful scrutiny. Therefore, capital inflow does not pose a serious threat to the government's strategy. China's currency is still pegged because the cost of sterilization is not yet unbearable. However, there might be negative consequences to this strategy as well. Paulson argues that despite the central bank's efforts to absorb the excess money by selling bonds and raising bank reserve requirements, China's attempt to keep the currency from appreciating has helped fuel inflation.[23] Therefore, from an inflation-controlling perspective, China should not peg its currency.

Some scholars think that the renminbi exchange rate issue has been exaggerated and that Chinese policymakers might not be concerned at all. Gang asserted that even in 2004, when RMB reached a historical low, the RMB/USD exchange rate was still close to its equilibrium point based on the

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[19] James Dorn, "Creating Financial Harmony: Lessons for China," *Cato Journal* 28, no. 3 (Washington, DC: Fall 2008): 547.
[20] J. Anderson, "How to Think About China, Part 3: The State of the Banking System," UBS Investment Research, *Asian Economic Perspectives* (Feb 2008): 21.
[21] James Dorn, "Creating Financial Harmony: Lessons for China," *Cato Journal* 28, no. 3 (Washington, DC: Fall 2008): 548.
[22] John Williamson, Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option. Institute for International Economics (Washington, DC: Sept 2000), 33–34.
[23] Paulson 2008, 62.

stability of trade surplus analysis.[24] Bhalla, with a different approach, finds that Chinese inflation was not too serious. In fact, between 1996 and 2007, Chinese inflation was almost exactly equal to U.S. inflation.[25] Prasad also realized that in early 2009 the case for undervaluation weakened as the pace of China's reserve accumulation fell sharply at the same time that capital inflows slowed and the trade surplus narrowed.[26] However, even if the upward pressure is exaggerated, China is still facing the problem of monetary policy inflexibility, as I mentioned above.

The economic reasoning provided above can only partially explain why the renminbi is still pegged. In fact, most of these explanations are only valid in the short run. In the long run, economic fundamentals taken for granted today may change, and the current economic factors will shift. Therefore, further investigation and more persuasive explanations are necessary.

Political Explanations

Internationally, the U.S. factor is unarguably the most important issue, because the United States is China's most important export market.[27] In September 2003 Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced the first congressional bill (S1586) targeting the value of the renminbi, then RMB 8.28 to the U.S. dollar. The United States has also tried to persuade Beijing that exchange rate flexibility is in China's own interest as well as the interest of the United States.[28] Ironically, an appreciation of the renminbi might not actually be in U.S. interest. Jobs lost in China would not automatically return to the U.S., but would reappear in countries like Vietnam and Bangladesh. In addition, the U.S. current account deficit as a whole, or even the deficit with China, would remain unchanged. Chinese policymakers may have foreseen this outcome and chose not to bother with

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[24] Yi Gang, "Renminbi Exchange Rates and Relevant Institutional Factors," *Cato Journal* 28, no. 2 (Washington, DC: Spring 2008): 188.
[25] Surjit Bhalla, "Economic Development and the Role of Currency Undervaluation," *Cato Journal* 28, no. 2 (Spring/Summer 2008): 325.
[26] Prasad 2009, 226–227.
[27] Ronald I. McKinnon, "China: A Stabilizing or Deflationary Influence in East Asia? The Problem of Conflicted Virtue," in *Exchange Rates Under the East Asian Dollar Standard: Living with Conflicted Virtue* (Cambridge, MA: MIT Press, 2005), 134.
[28] Gary Clyde Hufbauer and Claire Brunel, "The US Congress and the Chinese Renminbi." Debating China's Exchange Rate Policy. Peterson Institute for International Economics (Washington, DC: 2008), 219–220.

any currency adjustment since the United States would not be satisfied anyway.[29]

Empirical evidence suggests similar patterns. During the first six months of 2005, when the exchange rate was still entirely fixed, the United States ran a $90 billion trade deficit with China. Then, during the first half of 2008, when the renminbi neared its peak value against the dollar, the trade deficit exceeded $115 billion.[30] This demonstrates that a more expensive renminbi does not necessarily prevent the U.S.-China trade balance from widening.

In addition, the consequences China faces for pegging its currency are relatively small. Although the United States is becoming increasingly critical of China's exchange rate policy, it has declined to name China as a manipulator because it cannot establish "intent" to manipulate. The IMF even argued against labeling China as a currency manipulator because it might only discourage reform. The IMF penalty mechanism is also weak.[31,32,33] Thus, if it is not a necessity, and if there is no credible punishment or propelling force compelling it to do so, why should China be motivated to unpeg its currency?

On the other hand, having a steady currency might actually help the Chinese government gain political capital. During the 1998 financial crisis in East Asia, the cross-country spillover effects of devaluations among closely connected trading partners were enormous. These beggar-thy-neighbor devaluations imposed severe deflationary pressure on the dollar prices of goods and services traded in East Asia. Despite losing relative competitiveness to its neighbors and severe internal deflationary pressure, China still did not devalue its currency. China's steadfastness was later praised and, according to McKinnon, helpful for the economic recovery of the East Asian states.[34] It is unlikely that this would have occurred had China been on a floating currency regime or had the renminbi appreciated beforehand.

[29] Fan Gang, "Comment Renminbi Revaluation and US Dollar Depreciation." Debating China's Exchange Rate Policy. Peterson Institute for International Economics (Washington, DC: 2008), 71.
[30] Derek Scissors, "Deng Undone," *Foreign Affairs* 88, no. 3 (New York: May/June 2009): 27.
[31] Nicholas R. Lardy, "China in the World Economy," Institute for International Economics (Washington, DC: 1994).
[32] Jeffrey A. Frankel and Shang-Jin Wei, "Assessing China's Exchange Rate Regime," *Economic Policy* 22, no. 51 (2007): 575–627.
[33] Randall C. Henning, "Congress, Treasury, and the Accountability of Exchange Rate Policy: How the 1988 Trade Act Should Be Reformed," Peterson Institute for International Economics (Washington, DC: 2008).
[34] McKinnon 2005, 139–140.

Domestic political reasons for a pegged renminbi might be even more convincing than international ones. Compared with U.S. domestic politics, which are often used as an excuse for U.S. foreign policies, Chinese domestic politics involve a greater number of people. Although China is not technically democratic, domestic politics still constrain policymakers, especially when they are facing high pressure to create more jobs to ease social disparities.[35] Broz and Frieden, for example, mention that there is a tradeoff between stability and flexibility regarding balance of payment adjustments. Chinese policy obviously favors stability, as Deng Xiaoping's repeated phrase attests, "Stability trumps everything!"[36] Cruz and Walters agree, and there is considerable evidence that restrictions on currency convertibility are capable of providing financial stability and improving policy autonomy.[37] This is exactly what the Chinese government is looking for. It does not want social unrest that might challenge party rule, and it does not want instability to compromise the current economic growth.

The type of exchange rate policy a country adopts is also related to its regime-type. Broz and Frieden find that in countries where the stakes in elections are high, politicians might prefer floating exchange rates, so as to preserve the use of monetary policy as a tool for building support before elections.[38] In China, the stakes in elections are minimal since decisions are usually made before elections even take place. Therefore, any advantage provided by floating exchange rates cannot be utilized.

Pressure among the elites themselves is significant as well. Hall argues that banks lobby for exchange rate stability when they accumulate significant amounts of foreign debt.[39] The logic is similar in China, especially since the top leaders' children are in charge of the banks and large businesses.[40] When policymakers' own interest is linked to exchange rate stability, even if the rationale is not to peg, they would still prioritize self-interest — not to mention other influential interest groups' role in this decision-making process.

One interesting pattern I noticed is that exchange rates are usually more stable during regime changes, and that significant changes in exchange

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[35] Gang 2008, 71.
[36] Deng Xiaoping, "Stability Trumps Everything," Eighty Slogans of Chinese Communist Party (Dec 1990.), http://www.people.com.cn/GB/shizheng/252/5303/5304/20010626/497648.html.
[37] Moritz Cruz and Bernard Walters, "Is the accumulation of international reserves good for development?" *Cambridge Journal of Economics* 32, no. 5 (Oxford: Sept 2008): 677.
[38] Broz and Frieden 2001, 329.
[39] Michael Hall, "Why Peg? The Role of Capital Mobility and Financial Intermediation," *International Review of Applied Economics* 23, no. 5 (New York: Sept 2009): 577.
[40] "Zhong Guo Tai Zi Dang Ren Mai Guan Xi Wu Jia Zhi Bao," *Hong Kong Economics Daily* (April 2009), <http://www.peacehall.com/news/gb/china/2009/04/200904252003.shtml.

rates take place only after the top leader has secured his power. According to the data collected by Zhao, we can see a pattern: it is usually two to three years after the top leader rises to power that exchange rates start to move significantly. In the first three years after Deng took power (1978–1981), the exchange rate only moved from 1.6 to 1.7 RMB/USD. However, during the next four years it depreciated to 2.9 RMB/USD. Before Jiang took power in the early 1990s, the exchange rate was at 5.3 RMB/USD, a 212 percent depreciation since 1981. In the first three years of Jiang's era, the exchange rate fell from 5.3 to 5.7 RMB/USD. Four years later, it had depreciated to 8.28 — the lowest ever. Similar patterns occurred during Hu's leadership. The first three years he was in power, the exchange rate stabilized at 8.27 RMB/USD. Then, the next three years, it appreciated gradually against the dollar until it was less than 7 RMB/USD.[41] It seems that the top leaders, considering their own self-interest, do not want significant changes in the exchange rate that risk the stability of the country and security of their own power. Following this logic, if we do not see a policy shift during Hu's era, which ends in 2012; the next major exchange rate shift might not happen until 2017 — three years after the next leader takes power.

In addition, regime change in the Chinese government has an unwritten tradition. The top leader will have three roles: the president of the country, the chairman of the party, and the commander-in-chief of the military. These positions are not transferred to the next leader all at once. For example, when President Hu Jintao became the president of China in 2003, Jiang Zemin was still commander-in-chief. Such a transition usually takes a year or two to settle in. Therefore, suppose Xi Jinping — the most likely candidate for the next Chinese presidency — takes power in 2012, his priority will be to secure all of his power first, including the power to command the military. Any currency movement during this consolidation could potentially distract from this personal mission. Thus, because of this unwritten tradition, Xi cannot assume that he will be granted the three positions automatically.

A shift in Chinese policy is like maneuvering a big ship. Policymakers are familiar and comfortable with the current course. Even if shifting course means positive change, they will be careful to calculate everything before making such changes. Among those calculations lie the personal interests of the top leader(s). Therefore, only when such a decision

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[41] Zhao Haisheng, "1949 Nian Yi Lai Ban Ge Duo Shi Ji Ren Min Bi Dui Mei Yuan Hui Lu Chang Qi Bian Dong Qing Kuang Biao [Chart of USD/CNY exchange rate history since 1949]," http://www.cpaun.com/batch.download.php?aid=225 , http://www.bhzj.cn/kjts/ShowArticle.asp?ArticleID=135.

is in both the country's and the top leader(s)' interest would the Chinese seriously consider unpegging the renminbi.

Moreover, Cruz and Walters argue that countries building up reserves are evidently hoping to emulate those economies that escaped speculative attacks and/or capital flight during the financial crisis. China was one of the success stories mentioned.[42] China's intention to avoid speculation is obvious. In 2005, when China announced its shift from a dollar peg toward a more flexible regime pegged to a basket of 11 currencies, it deliberately avoided revealing the specific weights on the different currencies.[43] Spiegel estimated the possible weights, and Zeileis found out through calculation that the relative weight of U.S. dollar decreased.[44][45] According to Frankel, most "basket peggers" keep the weights in the basket secret so that they can preserve a degree of freedom from prying eyes.[46] The pegged currency and the secrecy of the temporary weighted basket were vital to China's success in maintaining financial as well as social stability.

Philosophical and Ideological Explanations

Chinese policymakers' decision making is also related to their philosophical and ideological tradition. Daoism is one of the few religions native to China. One of the core values of Daoism is Non-Action. The Master Lao Zi says that "all under Heaven is a spiritual vessel; it cannot be acted upon."[47] Someone who temporarily gains hold of something will quickly turn about and lose it. The best way to avoid this is to do nothing. In the context of the exchange rate policy, it means to let the exchange rate equilibrium find you, instead of constantly seeking the equilibrium yourself. Gang supports this argument by asserting that given the fast changes in the structure of the world economy and the recent turmoil in global financial markets, any exchange rate equilibrium may be short-lived.[48] Since working actively toward equilibrium might not actually contribute to a better outcome, why not be content where you already are?

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[42] Cruz and Walters 2008, 666.
[43] Jeffrey Frankel and Shang-Jin Wei, "Estimation of De Facto Exchange Rate Regimes: Synthesis of the Techniques for Inferring Flexibility and Basket Weights," IMF staff paper (July 2008), 386.
[44] Mark M. Spiegel, "A Look at China's New Exchange Rate Regime," FRBSF Economic Letter, 9/9 (2005, Issue 23), 1–3.
[45] Achim Zeileis, Ajay Shah, and Ila Patnaik, "Exchange Rate Regime Analysis for the Chinese Yuan," Research Report Series (2008).
[46] Frankel and Wei 2008, 404.
[47] Ralph Sawyer, *The Tao of Peace: Lessons from Ancient China on the Dynamics of Conflict* (Boston & London: Shambhala, 1999), 26.
[48] Gang 2008, 72.

The non-action philosophy also transfers the blame to other actors. This is because actors cannot be blamed for their non-existing action. For example, when the United States depreciates the dollar, countries losing their competitive edge are displeased with the U.S. Yet since the renminbi is pegged to the U.S. dollar, it depreciated along with the USD. However, because the Chinese government was not the decision maker of the depreciation, the blame is on the United States rather than on China. Moreover, any benefit of this U.S. decision is diffused through all the currencies that pegged to the dollar, including the renminbi. Therefore, by pegging to the dollar China maintains the best of both worlds.

Ideology is another explanation for the current renminbi exchange rate policy. Broz and Frieden conclude that during the interwar period, the greater the concentration of left-wing representation in a state's government, the higher probability that a state maintained the gold standard throughout this period. Empirical evidence also suggested that leftist governments were very likely to commit to gold.[49]

Although China left the gold standard, its decision to peg to the U.S. dollar may follow a similar logic. Since "communism" is on the very left of the political spectrum, China may be committing to the U.S. dollar in return for credibility and stability. Kettell goes further to argue that exchange rate policymaking is a key component of a wider governing strategy that is designed by state managers with a view to containing class struggle, securing favorable conditions for capital accumulation, and providing a sufficient degree of governing autonomy for the pursuit of high political aims.[50]

Strategic Thinking and the Future

Besides the economic, political, philosophical, and ideological reasons explained above, we must also analyze the strategic thinking behind the exchange rate policymaking in China to help better understand the big picture and anticipate the future trend of the renminbi exchange rate. The U.S. government has been trying to push up renminbi's value for years. Once again, on October 16, 2009, the U.S. treasury department again criticized China for its buildup of foreign-exchange reserves and the renminbi's "lack of flexibility."[51] Nevertheless, China refused to budge.

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[49] Broz and Frieden 2001, 328.
[50] Steven Kettell, *The Political Economy of Exchange Rate Policy-Making: From the Gold Standard to the Euro* (New York: Palgrave Macmillan, 2004), 10.
[51] Rebecca Christie, "U.S. Criticizes China for Lack of Exchange-Rate Flexibility," Bloomberg (Oct 16, 2009), http://www.bloomberg.com/apps/news?pid=20601083&sid=aYdGzfZnFQJU.

One strategic explanation for China's resistance to adjustment is that the Chinese government may be waiting for a moment to use the exchange rate as a bargaining chip to ask (or coerce) the U.S. for a favor. Within the diplomatic context, it is quite common to exchange favors — or, depending on the context, to use a form of coercion. For example, Caryl recently argued that Kim Jong Il is not irrational, but rational for strategically blackmailing the world into handing over adequate food and money for him to keep his regime in power.[52] Therefore, even if China feels an economic or political need to change the exchange rate policy, it might be waiting to use it as a bargaining chip so that it will gain something from the United States as well — as the Chinese saying goes, "hitting two birds with one stone."

Another aspect of this strategic thinking, as mentioned above, is that "non-action" might be essential in the Chinese exchange rate policymaking. Chinese grand strategy, therefore, could be "non-action" in the short run, while planning to take one large cost-efficient step in the long run.[53,54] In the long run, the Chinese government may encounter beneficial alternatives that are not available in the short run. Eichengreen has suggested that a basket of currencies, or even the RMB in the far future, might actually replace the U.S. dollar as the international reserve currency. This would solve the dilemma that large reserve holders, like China, currently face by creating a real alternative to national currencies.[55] In the meantime, the Chinese government could try different short-term approaches, like increasing its domestic demand, to fundamentally alter the structure of Chinese growth factors.

A different strategic explanation is related to game theory. In the prisoners' dilemma, even though the best *combined* outcome is for both prisoners to cooperate and remain silent in the face of the charges against them, based on self-interest and individual risk analysis, the actual outcome is usually less favorable to both. This is the strategic equilibrium — also known as the Nash equilibrium. In the case of Chinese renminbi, it is very likely that the Chinese government is one of many "prisoners." To revalue the renminbi will be beneficial for China only if all other states pegged to the U.S. dollar do so as well. If only one state acts and no other state does, the one that revalues will lose its competitiveness. Therefore, unless there is a collaborative, multilateral appreciation of currencies pegged to the U.S. dollar, China is not likely to do it alone. Even if China fully understands the

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[52] Christian Careel, "The Hermit Kingdom: An unchanging, irrational Stalinist dictatorship? Not so much," *Foreign Policy* (Nov/Dec 2009): 31.
[53] Gang 2008, 70.
[54] Goldstein and Lardy 2008, 22.
[55] Eichengreen 2009, 56.

benefits of revaluing, it does not have the incentives to make a unilateral move away from this strategic equilibrium.

Conclusion

So why is the Chinese renminbi still pegged to the U.S. dollar? While the majority of International Political Economy literature argues that economics is the main factor behind this decision, this paper demonstrates that economic reasoning is not sufficient. Economic explanations such as "export dependency," "reserve accumulation," "favorable status quo," "successful sterilization," and "illusion of pegging" are weakened by convincing counterarguments and have trouble providing a comprehensive rationalization for China's exchange rate decision. The weakness of the economic explanation allows arguments drawn from Chinese politics, history, socio-cultural studies, and elite studies to fill the void.

Politically, China faces few negative international consequences for pegging; therefore, it lacks motivation to revalue. Furthermore, the 1997 Asian Financial Crisis demonstrated that pegged currencies generate stability, credibility, and political capital. Domestic explanations are even more persuasive. From the government's institutional structure to the influence of domestic interest groups, there is convincing evidence that Chinese policymakers have little interest in changing course. This paper also uncovered an interesting relationship between changes in Chinese leadership and exchange rate policy shifts, which may be useful for predicting future changes in the Chinese exchange rate. Ideological perspectives of Daoist tradition and evidence of left-leaning governments' past behavior also suggest that pegging may be a more stable exchange rate policy. Finally, this paper recognizes the strategic benefits China gains from its exchange rate policy, and concludes that the Chinese policymakers are unlikely to unpeg the renminbi in the short run.

Ultimately, by taking these political, philosophical, and strategic influences into account, this paper provides a stronger, more nuanced explanation for China's current exchange rate policy. Given the scope of the Chinese economy, the growth rate of its GDP, and the interdependent relationship between China and the capitalist world economy, this issue will become increasingly important and a concern of not just scholars, but also the common people of the globalized economy.