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Does China Really Say No? The Impact of International Political Pressure on China's Exchange Rate Policy

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From 2002, the Chinese government insisted that it would not give in to international pressure to change the renminbi (RMB) exchange rate regime. The main question asked in this paper is whether the Chinese government did resist this pressure from early 2002 to mid-2008. Judging from Chinese official documents, records released after bilateral meetings between the United States and China, testimony given by U.S. officials in the U.S. Congress, Chinese government policy statements, and measures related to the RMB exchange rate, we conclude that, in addition to economic and domestic factors, China's exchange rate policy was indeed influenced by American political pressure, and that this pressure led to reform of the RMB exchange rate regime and the widening of the floating band of the RMB exchange rate.

Keywords: Renminbi; exchange rate regime; exchange rate policy; China; United States.

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論 Discussion of foreign exchange rates is mainly based on international monetary theory which seeks to explain the economic implications of adjusting exchange rates. Most empirical studies of the Chinese renminbi (RMB) exchange rate have examined from an economic perspective what the equilibrium exchange rate of the RMB should be and how much the RMB is undervalued compared to the equilibrium exchange rate.[1]

However, the RMB exchange rate is controlled or at least significantly affected by the Chinese government and is not solely determined by market forces. Most studies do no more than suggest how the government should adjust the exchange rate; they do not necessarily explain the rationale behind China's exchange rate policy and actual changes in the exchange rate. The core question concerning the RMB exchange rate is what factors drive the Chinese government's foreign exchange rate policy. Of course, there is no denying that economic factors have an important impact on exchange rate policy, but there are other forces influencing it.

Some scholars assert that, in addition to economic factors, movements in foreign exchange rates are also affected by domestic political factors. These studies point out that under pressure to achieve reelection, policy-makers will use exchange rate policy to promote economic growth. In addition, domestic interest groups will seek to influence the government's exchange rate policy through lobbying or by making political financial contributions. These studies examine the factors that determine exchange rates, including electoral motivation, institutional motivation, partisan incentives, and the lobbying of interests groups.[2]

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[1]William R. Cline and John Williamson, "Estimates of the Equilibrium Exchange Rate of the Renminbi: Is There a Consensus and, If Not, Why Not?" in *Debating China's Exchange Rate Policy*, ed. Morris Goldstein and Nicholas R. Lardy (Washington, D.C.: Peterson Institute for International Economics, 2008): 131-68.

[2]These studies include: Pierre-Guillaume Méon, "A Model of Exchange Rate Crises with Partisan Governments," *Journal of Macroeconomics* 23, no. 4 (October 2001): 517-35; S. Brock Blomger and Gregory D. Hess, "Politics and Exchange Rate Forecasts," *Journal of International Economics* 43, nos. 1-2 (August 1997): 189-205; Bento J. Lobo and David

Some scholars, including Steinberg and Shih and Liu et al.,[3] hold that external pressures play little or no role in determining China's exchange rate. They argue that domestic interest groups provide the key to understanding China's exchange rate policy and that alternative explanations, such as those based on external pressures, are inadequate.

Liu et al. use event study methodology to investigate the effect of external political pressure on the Chinese exchange rate. Their finding is that external political pressure has no significant influence on the RMB exchange rate. Nevertheless, several caveats should be added to their research. First, they do not consider the affect of international political pressure on the July 21, 2005, exchange rate reform. Second, it is very difficult to differentiate and quantify the data they use from the Reuters News database to gauge the reaction of the Chinese government and detailed interaction between China and the international community based upon headline news keywords statistics. Joint statements released after bilateral meetings or policy statements might consist of rhetoric rather than detailed positions.

Third, even after China's exchange rate reform of July 21, 2005, the value of the RMB was still tightly controlled by the Chinese government and allowed to float within a 0.3 percent band. This change in exchange rate policy might be seen as a sudden response to cumulative international political pressure instead of part of a gradual response to each instance of external political pressure. As a result, quantitative analysis reveals that because of the controlled float, there was little correlation between external events and fluctuations in the RMB exchange rate between July 22, 2005, and December 2007. Finally, Liu et al. do not give different

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Tufte, "Exchange Rate Volatility: Does Politics Matter?" *Journal of Macroeconomics* 20, no. 2 (April 1998): 351-65; Marina Arbetman, "The Impact of Politics on Exchange Rate Fluctuations: The Untold Story," *International Interactions* 21, no. 2 (1995): 127-53.

[3]David A. Steinberg and Victor C. Shih, "Interest Group Influence in Authoritarian States: The Political Determinants of Chinese Exchange Rate Policy," *Comparative Political Studies*, online version, March 14, 2012, http://cps.sagepub.com/content/early/2012/02/28/0010414012437168.full.pdf+html; Liu Li-Gang and Laurent L. Pauwels, "Do External Political Pressures Affect the Renminbi Exchange Rate?" (Hong Kong Monetary Authority, Working Paper 05/2008).

weights to different external events according to the countries they originate from and their official rankings.

Steinberg and Shih argue that interest groups have a strong influence on China's exchange rate policy. The Chinese government needs to balance both internal and external economic and political forces when it decides its policy. Therefore, as these authors suggest, the Chinese government does consider and concede to the demands of interest groups within China. However, their conclusion does not exclude the impact of external political pressure on China's exchange rate policy.

There is no denying that China's exchange rate policy is influenced by many factors, including international financial forces and domestic political and economic factors as the previous literature asserts. This paper examines whether or not China's exchange rate reform was influenced by international political pressure between early 2002 and mid-2008.

After explaining the research methods used in this study, we shall present the changes in China's exchange rate policies before and after the reform of the RMB exchange rate regime on July 21, 2005. The final section will consist of a discussion of our results and a conclusion.

Research Method

The Qualitative Analysis Approach

In order to carry out a quantitative analysis of the influence of international political pressure (independent variable) on exchange rate policy (dependent variable) it is necessary to collect quantitative data on this international political pressure. However, there is no objective and reasonable way of quantifying international political pressure. It might be possible for a researcher to establish his/her own standard of quantification, but such a standard might not be objective or consistent, and may not be acceptable to other scholars, as it would be influenced by the researcher's subjective judgment.

Since devising quantitative standards for international political pressure is likely to be controversial, this paper will conduct a qualitative analysis, using logical reasoning to establish the relationship between international political pressure and changes in China's exchange rate policy. This study uses Chinese explanations of its exchange rate policy, variations in that policy, adjustments in the RMB exchange rate, the process of international political interaction, and the comments and unilateral action of various foreign governments to understand the influence caused by international political pressure on China's exchange rate policy. Besides this, we also discuss the relationship between currency appreciation and economic factors such as inflation and external economic balance.

Defining International Political Pressure and China's Exchange Rate Policy

In this paper, interaction between the United States and China will be used to observe international political pressure. China's trade surplus with the United States was larger than its surplus with any other country during the observed period, and the United States was the country that exerted the most pressure on China to change its exchange rate. For these reasons, U.S.-China interaction is likely to be the best indicator of the content and impact of international political pressure on China's exchange rate policy.

We also examine important policy statements and actions of the Chinese government to assess whether China has been influenced by international political pressure to change its exchange rate policy. Despite the fact that the Chinese government's public statements may not coincide with its actual policies, and that outsiders are unable to spy on the process of China's decision-making, this paper makes cross validations between official Chinese statements and policy actions, as well as official U.S. policy statements and testimony in Congress, in an attempt to ascertain the actual influence of international political pressure on China's exchange rate policy.

There are, however, several factors that might intertwine and reinforce each other. For instance, international political pressure might trigger capital flight from a country and thus impose tremendous devaluation pressure on its currency in the foreign exchange market; a fragile domestic economy or insufficient foreign exchange reserves will make a country vulnerable to external pressure. No model has yet been devised that includes all potential factors and distinguishes the relative importance of each of these factors. In this case study, we intend to investigate whether China's exchange rate policy is, as the Chinese government has asserted, completely free of the influence of international political pressure.

Scope of Research

The timeframe of this paper ranges from January 1, 2002, to July 20, 2008, with July 21, 2005, as the pivotal date. The RMB exchange rate became the focus of attention and pressure from the international community in 2002. China adjusted its exchange rate regime and made a substantial adjustment in the RMB exchange rate on July 21, 2005. In July 2008, a full three years after this adjustment, the global financial crisis that stemmed from the U.S. subprime loans crisis significantly changed the global financial and economic environment. This is why it is better to analyze the influence of the international political pressure on China's exchange rate policy in a more consistent setting, i.e., before July 2008.

The period under analysis in this paper begins on December 31, 2003. After the July 2005 reform, we could have chosen March 1, 2006; January 1, 2007; and July 20, 2007, as our cut-off point. These were dates when China began to show changes in its attitude under international political pressure. At different points in time, the Chinese government began to adjust its viewpoints or policy toward the RMB exchange rate.

The Period Prior to China's Exchange Rate Regime Reform

January 1, 2002 ~ December 31, 2003

The U.S. economy entered a period of recession in 2001 and the unemployment rate in U.S. manufacturing industry increased substantially. The U.S. unemployment rate rose from 4 percent in 2000, to 4.7 percent in 2001, 5.8 percent in 2002, and 6 percent in 2003. The number of workers employed in manufacturing industry declined continuously from 17.26

million in 2000, 16.44 million in 2001, to 15.25 million in 2002.

Meanwhile, according to U.S. statistics, the U.S. trade deficit with China increased from US$83.0 billion in 2001 to US$124.0 billion in 2003. The U.S. government was deeply concerned about this huge trade deficit, believing that China had gained an unfair competitive edge on account of an undervalued RMB.

In June 2003, John W. Snow, the secretary of the U.S. Treasury, brought up the RMB issue with the Chinese for the first time, and he urged the Chinese government to implement a more flexible exchange rate regime. The Chinese government insisted that its long-term goal was to do just that during Snow's visit to China in September that year. Nevertheless, Snow stressed that it would be no use setting up a schedule for exchange rate reform at that time.[4]

Because Snow failed to extract a firm undertaking from China when it would begin to allow the RMB to appreciate, members on both sides of the U.S. Congress proposed a series of related bills, pressuring the U.S. government to take action to force the Chinese to allow the RMB to appreciate substantially. On September 5, Congressmen Charles Schumer (Democrat) and Lindsey Graham (Republican) proposed a bill that would levy a 27.5 percent punitive tariff on Chinese goods in order to compensate for the advantage gained by Chinese enterprises through the undervalued RMB.[5]

In its public response, the Chinese government insisted that the RMB was not undervalued. Dai Xianglong (戴相龍), the former governor of the People's Bank of China (PBoC), pointed out that the RMB had appreciated by a nominal 17.9 percent against the euro and 17.0 percent against the Japanese yen between 1994 and 2002. Taking inflation into account, these percentages would be 39.4 percent and 62.9 percent, re-

[4]John Snow, "Press Roundtable Transcript with Treasury Secretary Snow in Beijing, China on September 3, 2003," U.S. Department of Treasury, September 3, 2003.

[5]Charles Schumer and Lindsey Graham, "S.1586: A Bill to Authorize Appropriate Action If the Negotiations with the People's Republic of China Regarding China's Undervalued Currency and Currency Manipulations Are Not Successful," United States Senate, September 5, 2003.

spectively. Therefore, Dai argued, there was no basis for arguing that the Chinese government had intentionally undervalued the RMB.[6]

Although China's public response to requests from the international community was unyielding, the statements and testimony of U.S. officials, made after meetings with their Chinese counterparts, gave the impression that there was a consensus between the United States and China on the RMB issue. During a press conference after his meeting with Chinese officials in September 2003, Snow said that he was encouraged that the Chinese government had reaffirmed their longstanding goal of moving toward greater currency flexibility.[7] In his testimony to Congress on October 30, Snow said that "the governor of PBoC, Zhou Xiaochuan (周小川), committed that role of market will become increasingly important in the formation mechanism of the RMB exchange rate and the exchange rate of RMB will be finally determined decisively by the market forces."[8]

In 2003, when international political pressure started, in addition to trying to convince the United States China also promised that it would advance toward a flexible RMB exchange rate regime. Snow's statements show that China made repeated promises on the RMB issue in bilateral talks, and also explained to the Americans why it did not make changes immediately. These explanations were recognized by the U.S. government.

In addition to these interactions between finance and central bank officials on the two sides, China also took action in response to pressure from the international community. In its Monetary Policy Report (MPR) for the second quarter of 2003, published in August that year, the PBoC announced that "China will perfect the RMB exchange rate formation mechanism." Nothing of this sort had been included in previous reports, and this was the first time that the Chinese had officially expressed their

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[6]Jianhong Zhu, "Renminbi huilü zhidu dui shijie douyou haochu" (RMB exchange rate system is of benefit to the world), *Renmin ribao* (People's Daily) (Beijing), March 24, 2003.

[7]John Snow, "Press Roundtable Transcript with Treasury Secretary Snow in Beijing, China on September 3, 2003," U.S. Department of Treasury, September 3, 2003.

[8]John Snow, "Testimony of Treasury Secretary John Snow before the Senate Committee on Banking, Housing and Urban Affairs," U.S. Department of Treasury, October 30, 2003.

intention to explore and research changes to the RMB exchange rate regime.

In addition, China took action to improve the situation of its continuously increasing foreign exchange reserves. In November 2003, the Chinese government raised the amount of foreign currency that Chinese travelers were allowed to take out of the country from US$3,000 to US$5,000. In late 2003 and early 2004, the Chinese government dispatched three groups to the United States to purchase American products. In this way, the Chinese hoped to satisfy U.S. anxiety about the enormous trade deficit with China.

It is clear that in public, China refused to yield to pressure from the United States, insisting that there was no reason for it to change its RMB exchange rate regime. However, when it came to actual policies, China was prepared to adopt measures to relieve pressure from the United States. What is more, in closed-door dialogue with the United States, China's attitude to exchange rate reform was obviously less tough than it was on public occasions.

January 1, 2004~ July 21, 2005

In 2003, China's foreign exchange reserves reached US$403.2 billion, an increase of US$116.8 billion since 2002. The U.S. trade deficit with China also increased to US$124.1 billion (U.S. statistics, hereafter), accounting for one-fourth of the entire U.S. trade deficit. The following year, China's foreign exchange reserves increased to US$609.9 billion and its trade surplus with the United States reached US$191.9 billion. The number of workers employed in U.S. manufacturing industry declined to 14.51 million in 2003 and to 14.31 million in 2004.

On January 21, 2004, President George W. Bush directly criticized China's monetary and trade policies and said that the Chinese government had "got to deal with their currency."[9] On February 10, responding

[9]US White House, "President Discusses Job Training and the Economy in Ohio," U.S. White House, January 21, 2004.

to Bush's speech, Premier Wen Jiabao of China said that exchange rate reform was mainly focused on two things—gradually perfecting the RMB exchange rate formation mechanism and maintaining the basic stability of the RMB exchange rate at a reasonable and balanced level.[10] In the past, Wen had merely said that China "would explore and perfect" the RMB exchange rate formation mechanism in the course of deepening financial reform; now, however, he was talking about "gradually perfecting" it.

On March 25, when testifying before Congress, Snow appealed to China to allow the RMB to float as soon as possible. He noted in his testimony that, "to facilitate China's transition to a flexible regime, the Treasury Department and China's central bank have already begun a Technical Cooperation Program. China is also accelerating liberalization of its capital account and taking major actions to shore up its banking system."[11] On October 1, in a joint statement issued by the U.S.-China Joint Economic Committee (JEC), it was stated: "The Chinese side reaffirmed China's commitment to further advance reform and to push ahead firmly and steadily to a market-based flexible exchange rate, and described the steps the Chinese government has taken to create conditions to establish a more flexible exchange rate."[12]

The U.S. trade deficit with China hit a record high in 2004. In the face of U.S. demands that the RMB be allowed to appreciate so as to improve the U.S. trade deficit, the Chinese government immediately argued that the RMB was not undervalued. Zhou Xiaochuan said, "According to the international balance of payments, China's current account is basically balanced, and if anything there is a slight surplus."[13]

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[10]Xinhuanet, "Wen Jiabao: jingji fazhan chu zhongyao guankou hongguan tiaokong zhiguan zhongyao" (Wen Jiabao: economic development of China is at an important juncture; proper macro adjustment and control is of vital importance), *Xinhuanet*, February 10, 2004, http://news.xinhuanet.com/newscenter/2004-02/10/content_1308001.htm (accessed January 25, 2008).

[11]"Testimony of Treasury Secretary John W. Snow before the Committee on Financial Services, U.S. House of Representatives," U.S. Department of Treasury.

[12]"Joint Statement 16th Session of U.S.-China Joint Economic Committee," U.S. Department of Treasury, October 1, 2004, http://www.treas.gov/press/releases/js1972.htm.

[13]Xinhuanet, "Yanghang hangzhang Zhou Xiaochuan cheng: renminbi huilü meiyou bei

However, once again members of both parties in the U.S. Congress introduced bills that were designed to put pressure on China to take action.[14] On April 6, 179 members of the House of Representatives proposed the China Currency Bill, according to which the deliberate undervaluing of a currency by a foreign government to obtain an unfair competitive edge was classed as manipulation of exchange rates, and the U.S. International Trade Commission would be required to investigate whether such manipulation was actually taking place.[15]

Faced with lack of action by China and pressure from Congress, the U.S. executive branch began to take a tougher attitude toward the Chinese government. On April 14, President Bush said that now was the time for China to adopt a more flexible exchange rate and allow the RMB to appreciate. On April 16, Snow made a statement after the G-7 Financial Officials' Conference in which he stated, "China has taken numerous steps over the last few years, including preparing for greater flexibility in their exchange rate. With this groundwork in place, China is ready now to adopt a more flexible exchange rate."[16]

In response to U.S. pressure, senior Chinese officials began talking about the timing of RMB exchange rate reform, rather than issuing vague and general statements. On March 29, 2005, Zhou Xiaochuan said, "China will promote RMB exchange rate reform actively in a planned way, and choose a suitable time to unveil it."[17] On April 27, Premier Wen Jiabao said that the unveiling of the RMB reform might come as a "surprise."[18]

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dafu digu" (Governor of PBoC Zhou Xiaochuan: RMB exchange rate is not undervalued), *Xinhuanet*, February 5, 2005, http://www.xinhuanet.com/.

[14]Joseph I. Lieberman, "109th Congress 1st Session S.377, Fair Currency Enforcement Act of 2005 (Introduced in Senate)," Senate of the United States, February 15, 2005.

[15]"H. R. 1498: Chinese Currency Act of 2005 (Introduced in House)," House of Representatives of the United States, April 6, 2005.

[16]John W. Snow, "Secretary John W. Snow Prepared Statement Following the Meeting of the G-7 Finance Ministers and Central Bank Governors," U.S. Department of Treasury, April 16, 2005.

[17]People's Bank of China, "Zhou Xiaochuan hangzhang jieshou renmin ribao zhuanfang" (Governor Zhou Xiaochuan is interviewed by *People's Daily*), March 29, 2005.

[18]Jian Wang, "Renminbi huilü tiaozheng shangtou naojin" (Adjusting the RMB exchange

Although both Zhou and Wen avoided specifying the timing of RMB exchange rate reform, it was clear that the Chinese government was actually planning the reform.

On May 14, Zhou Xiaochuan mentioned that during the process of reform, the Chinese government would listen to opinions from all quarters and take *external pressure* into account, and they would also pay a great deal of attention to the impact of the Chinese economy on neighboring countries.[19] This was the first time that a senior Chinese decision-maker had mentioned taking external pressure into account with regard to RMB exchange rate reform. On June 8, when talking about reform of the RMB exchange rate regime, Zhou mentioned that international pressure was not only economic, it was also *political*.[20] Thus the Chinese government was now admitting that international political pressure could have an influence on China's exchange rate policy.

The PBoC had always stressed that it was necessary to maintain a stable RMB exchange rate while further perfecting the exchange rate formation mechanism. However in the MPR for the fourth quarter of 2003, published in February 2004, this sentence was rearranged, to read, "perfect the RMB exchange rate formation mechanism to maintain the basic stability of the RMB exchange rate at a reasonable and balanced level."[21] This shows that perfecting the RMB exchange rate formation mechanism was seen as a first step, or a parallel step, to maintaining a stable exchange rate.

In 2004, the Chinese government was striving to maintain the international balance of payments in order to ease international political pressure to revalue the RMB. In May that year, export subsidies and export re-

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rate is a knotty problem), *Zhongguo maoyibao* (China Trade News) (Beijing), April 28, 2005.

[19]Jianying Yang, "Zhou Xiaochuan cheng renminbi shengzhi yali bingbushi zuizhongyao de" (Zhou Xiaochuan: RMB appreciation pressure is not most important), *Jinrong shibao* (Financial Times) (China), May 14, 2005.

[20]Min Liu, "Yong jianjin banfa gaige renminbi huilü jizhi" (Using gradual measures to reform RMB exchange rate mechanism), *Jinrong shibao* (Financial Times) (China), June 8, 2005.

[21]People's Bank of China, "China Monetary Policy Report Quarter 4, 2003."

bate subsidies were cut or abolished altogether, and on May 1, China eased its management of foreign exchange accounts opened by various kinds of enterprises under current account. On August 1, China began to permit multinational companies to purchase foreign exchange and pay specific non-trading fees overseas. On August 17, China allowed social security funds and insurance companies to invest in overseas securities on a trial basis.

Finally, at 7.00 p.m. on July 21, 2005, the Chinese government made a "surprise" announcement that the exchange rate of the RMB against the U.S. dollar had increased by 2.1 percent, so that one U.S. dollar was now worth 8.11 RMB. The floating band was 0.3 percent, and the RMB was to be linked to a basket of currencies.

During this period, the Chinese continued to revise their attitude toward exchange rate policy. Having originally maintained that there was nothing wrong with the exchange rate and there was no necessity for adjustment, they began to acknowledge that a floating RMB would be the ultimate goal of future reform. They then said that they would explore and perfect the RMB exchange rate formation mechanism, and that exchange rate reform would come as a surprise. Finally, on July 21, 2005, the Chinese government announced the change in its exchange rate policy.

It is clear from U.S. government sources that China had repeatedly promised the United States that it would reform its exchange rate, and it was willing to devise some cooperative plans with the United States in preparation for that reform. However, China's lack of action made the U.S. government pressure the Chinese even more. After March 2005, the Chinese government did not scruple to admit that international political pressure was an important factor influencing China's exchange rate policy.

After the Exchange Rate Regime Reform

July 22, 2005 ~ March 1, 2006

After the RMB regime was reformed on July 21, 2005, the margin of appreciation was extremely limited. From the original rate of 8.11 RMB to the U.S. dollar, the RMB rose in value to 8.0911 to the dollar by mid-

Table 1
U.S. Trade Deficit with China (U.S. statistics)

Unit: billion

Year	Export	Import	Balance (deficit)
2000	16.2	100.0	83.8
2001	19.2	102.3	83.1
2002	22.1	125.2	103.1
2003	28.4	152.5	124.1
2004	34.8	196.7	161.9
2005	41.9	243.5	201.6

Source: U.S. Census Bureau, http://www.census.gov/foreign-trade/balance/c5700.html.

September, an appreciation of only 0.23 percent in roughly two months. This was less than the *daily* floating band of 0.3 percent. By the end of 2005, the RMB had appreciated by a mere 4.83 percent. This shows that the Chinese government was still strictly controlling fluctuations in the RMB exchange rate.

Meanwhile, China's trade surplus with the United States did not decrease along with the exchange rate reform. In 2005, the deficit reached US$201.6 billion. In the opinion of the U.S. government, this was because the RMB did not appreciate fast enough (see table 1).

Given the limited appreciation of the RMB, the United States began to urge China to increase exchange rate flexibility and speed up the pace of RMB reform. Zhou Xiaochuan responded on September 9, 2005, by explaining that China needed time to adjust to the new exchange rate system. On September 13, President Bush told President Hu Jintao (胡錦濤) of China to increase the floating band of the RMB exchange rate, allowing the currency to appreciate faster.

On October 6, members of the U.S. Congress once again started to put pressure on China. Three Democratic senators, Evan Bayh, Charles Schumer, and Debbie Stabenow, proposed a resolution requiring the executive branch to order U.S. representatives in the International Monetary Fund (IMF) to investigate whether China had conducted large-scale interference in the foreign exchange market in order to hold back RMB appreciation artificially.[22]

On October 16, Snow proposed to China that it speed up the process of making its exchange rate system more flexible. Snow said that the "executive branch needs more evidence of China's reform measures in exchange rate regime to oppose legislation of Congress. We haven't determined what we will say yet in the semi-annual report which submitted to Congress but we will continue to look hard at the situation and try and evaluate whether or not sufficient progress is being made."[23]

With pressure coming from both the U.S. executive branch and Congress, during a meeting of the U.S.-China Joint Economic Committee on October 17 China once again promised the United States that it would reform its exchange rate system. After the meeting, the two parties issued a joint statement, pointing out that "China affirmed their intention to enhance the flexibility and strengthen the role of market forces in their managed floating exchange rate regime."[24]

On November 4, Zhou Xiaochuan stressed that China's economy had enough flexibility to free up the RMB exchange rate still further. He criticized Chinese economists for adopting "very simplified models" to estimate the RMB equilibrium exchange rate, and said that such models "under-estimate export elasticity, import elasticity and the elasticity of the entire national and international economy."[25] Zhou was using economic arguments to rationalize a future increase in exchange rate flexibility for fear that others might think that the Chinese government was succumbing to international political pressure.

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[22]Evan Bayh, Debbie Stabenow, and Charles Schumer, "S. RES. 270 Expressing the Sense of the Senate that the International Monetary Fund Should Investigate Whether China Is Manipulating the Rate of Exchange between the Chinese Yuan and the United States Dollar," U.S. Senate, October 6, 2005.

[23]"China Needs More Currency Regime Flexibility," *Xinhua Financial Network News*, October 17, 2005.

[24]"Joint Statement 17th Session of U.S.-China Joint Economic Committee," U.S. Department of Treasury, October 17, 2005, http://www.treas.gov/press/releases/js2987.htm.

[25]"Renminbi keneng shengzhi" (RMB may appreciate), *Zhongguo shibao* (China Times) (Taipei), November 6, 2005, A13.

The first action of the PBoC was to announce that the floating band of the RMB exchange rate against the euro and the yen would increase from 1.5 percent to 3 percent. Then, in the MPR for the third quarter of 2005, published on November 9, the PBoC stated that "since July 21, the exchange rate of the RMB to the U.S. dollar has varied, and the flexibility is getting stronger gradually." This phrase was changed to "flexibility is strengthened" in the MPR for the fourth quarter of 2005. Then in January 2006, the PBoC introduced a mechanism for over-the-counter (OTC) transactions in the interbank foreign exchange market, in order to develop the foreign exchange market, improve the RMB exchange rate system, and strengthen the competitiveness of financial institutions. This represented a further marketization of the RMB exchange rate formation mechanism. Finally, China dispatched three groups to the United States to purchase products, hoping to ease pressure to revalue the RMB that stemmed from the United States' enormous trade deficit with China in 2005 and 2006.

The quite limited margin of RMB appreciation made the United States continue to put pressure on China to increase the floating band. Publicly, the Chinese government tried to convince the international community that it needed time to adjust to the new exchange rate system and that RMB exchange rate flexibility had indeed been strengthened. In addition, the Chinese government promised the United States that it would strengthen the role of market forces in deciding the RMB exchange rate. China's actions included introducing the mechanism of OTC transactions into the foreign exchange market and trying to reduce China's trade surplus with the United States by purchasing more U.S. products.

March 2, 2006 ~ December 31, 2006

In 2005, China's foreign exchange reserves increased to US$818.9 billion; at the same time, the U.S. trade deficit with China reached a record high of US$201.6 billion, an increase of US$38.0 billion over 2004. From the time of the exchange rate reform on July 21 up to the end of that year, the RMB had appreciated by a mere 0.483 percent.

The Chinese government began to say publicly that it was willing to increase exchange rate flexibility. On March 14, 2006, Premier

Wen Jiabao (溫家寶) said, "China will perfect the RMB exchange rate formation mechanism further and expand the foreign exchange market to increase RMB exchange rate floating flexibility."[26] Then, on March 20, Zhou Xiaochuan added, "After the exchange rate reform, the majority of Chinese enterprises accepted and adjusted to the reform through undergoing arduous adjustment; . . . we can let market supply and demand gradually exert greater functions on exchange rate floating."[27]

The U.S. government grew impatient with China's vague and general promises. On May 18, Snow sharpened his tone when he asked China to speed up exchange rate flexibility, saying, "The United States is extremely dissatisfied with the slow and disappointing pace of reform of the Chinese exchange rate regime. The RMB's appreciation has done little to curb China's large current account surplus or cool its fast-growing economy."[28] However, on September 12, Wen Jiabao retorted on the problem of China's trade surplus by attributing it to international comparative advantage and industrial transfer among countries.[29]

In addition to indicating that it was willing to increase RMB exchange rate flexibility, the Chinese government took the initiative in March 2006 by inviting Congressmen Schumer and Graham, two of the main critics of China on the currency issue, to visit China. The aim of this invitation was to reduce the pressure from the U.S. Congress.

In April 2006, the PBoC further relaxed its current account in order to reduce the accumulation of foreign exchange reserves. Finally, in the

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[26] "Wen Jiabao: Renminbi huigai buhui zaifasheng chuqibuyi de shiqing" (Wen Jiabao: there won't be any more surprises in RMB exchange rate reform), *Xinhuanet*, March 14, 2006, http://news.xinhuanet.com/video/2006-03/14/content_4302320.htm.

[27] Zhou Xiaochuan, "Zhongguo de maoyi pingheng he huilü youguan wenti" (Questions related to China's balance of trade and foreign exchange rate), People's Bank of China, March 20, 2006.

[28] John Snow, "Statement of Treasury Secretary John W. Snow before the Senate Committee on Banking, Housing, and Urban Affairs on International Economic and Exchange Rate Policies," U.S. Department of Treasury, May 18, 2006.

[29] "Wen Jiabao: Zhongguo shixing jinchukou jiben pingheng fangzhen bukeyi zhuiqiu shuncha" (Wen Jiabao: China works hard to maintain a basic balance between imports and exports and does not seek an excessive surplus), *Xinhuanet*, September 12, 2006, http://news.xinhuanet.com/world/2006-09/12/content_5082196.htm.

MPR for the first quarter of 2006, the bank announced that "increasing the flexibility of RMB exchange rate floating" would be the direction of future exchange rate policy.[30]

At this stage, negotiation between the United States and China on the RMB issue was focused on the exchange rate fluctuation margin as well as the pace of appreciation. The United States continued to express its dissatisfaction with the size of the fluctuation margin and slow pace of appreciation. China promised to increase RMB exchange rate flexibility and to allow market forces to have more influence on the exchange rate. The invitation of Schumer and Graham to China in particular highlighted the influence of international political pressure on the Chinese government.

January 1, 2007~ July 20, 2007

According to U.S statistics, the U.S. trade deficit with China reached US$232.4 billion in 2006, an increase of US$30.8 billion over the previous year and accounting for 30.6 percent of the entire U.S. external trade deficit. Even according to Chinese statistics, China's trade surplus with the United States increased 26.2 percent that year and accounted for 81 percent of China's entire trade surplus (see table 2).

Although China promised to increase exchange rate flexibility, the margin of RMB exchange rate appreciation did not meet U.S. expectations. From July 22, 2005, to the end of 2006, the RMB appreciated by only about 3.67 percent. Meanwhile, by the end of 2006, China's foreign exchange reserves had again hit a record high of US$1,200 billion.

On January 9, 2007, during a meeting of the Bank for International Settlement (BIS), Zhou Xiaochuan said that if China's trade surplus continued to rise, RMB exchange rate flexibility would be increased accordingly. More specifically, Zhou promised that *if the U.S.-China trade deficit continued to expand, exchange rate flexibility would definitely be enhanced*.[31]

[30]"China Monetary Policy Report Quarter 1, 2006," People's Bank of China, May 31, 2006.
[31]Guo Fenglin, "Zhou Xiaochuan: miandui liudongxing guosheng, bupaichu yunyong

Table 2
Balance of Trade between the United States and China

Unit: US$ billion

Year	U.S. statistics (U.S. trade deficit)	Chinese statistics (China trade surplus)
2005	-201.5	114.3
	(28.2%)	(112%)
2006	-232.4	144.3
	(30.6%)	(81%)
2007 (January-June)	-117.5	73.9
	(31.4%)	(66%)

Note: Figures in parentheses indicate the trade deficit (surplus) with China (United States) as a percentage of the total deficit (surplus).

Source:
1. U.S. Census Bureau (2007).
2. National Bureau of Statistics of China (2007).
3. General Administration of Customs, China (2007).

In fact, Zhou Xiaochuan had already given his assurances on this during a private meeting with U.S. officials. When testifying to Congress on January 31, Henry Paulson, who had taken over from Snow as secretary of the Treasury, said that "China agrees they need to introduce currency flexibility and move to a floating exchange rate, they are not moving quickly enough for the United States or the rest of the global community."[32]

On March 3, Wen Jiabao publicly announced that China was willing to further perfect the RMB exchange rate formation mechanism.[33] On March 5, Zhou Xiaochuan also said specifically that the RMB ex-

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gengduo tiaokong cuoshi" (Zhou Xiaochuan: China is not ruling out the possibility of using more control measures when facing too much liquidity), *Xinhuanet*, January 9, 2007, http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune//2007-01/09/content_5581008.htm (accessed January 25, 2008).

[32]Henry M. Paulson, "Testimony of Treasury Secretary Henry M. Paulson on the Report on International Economic and Exchange Rate Policies before the Committee on Banking, Housing, and Urban Affairs," U.S. Department of Treasury, January 31, 2007.

[33]"China Vows to Improve Setting of RMB Exchange Rate," *Xinhua General News Service*, March 3, 2007.

change rate would be decided by supply and demand in the market, and that it might be possible to expand the floating band. Zhou added that this would depend on supply and demand as well as any imbalance in the international balance of payments.[34] This shows that under international pressure resulting from China's ever growing trade surplus, Chinese leaders were willing to increase the floating band of the RMB exchange rate.

On May 23, during a press conference prior to the U.S.-China Strategic Economic Dialogue (SED), Vice Premier Wu Yi (吳儀) urged the United States not to politicize the exchange rate issue. However, judging from Paulson's statement at the press conference after the meeting, the Chinese government's attitude was not as tough as indicated by Wu Yi. Paulson said that ". . . we make the case and they listen and they are moving the Renminbi. They have widened the band. . . . They agree with us on principle. The question is the pace of change."[35]

On May 18, prior to the SED, the PBoC had announced that it would enlarge the trading range of the RMB/US$ exchange rate to 0.5 percent from the previous 0.3 percent.

In the 486 trading days from the date of the reform in July 2005 to July 21, 2007, there were only two occasions on which the fluctuation margin of the RMB/US$ exchange rate had reached 0.3 percent. Those were June 12, 2007, when it appreciated by 0.404 percent, and July 12, 2007, when it had fluctuated by 0.313 percent. Both of these appreciations occurred after the Chinese government expanded the RMB exchange rate band in 2007.

There were only six days when the fluctuation margin was between 0.2 percent and 0.3 percent and only fifty-four days when it was between 0.1 percent and 0.2 percent. On 424 days, or 87.3 percent of all trading days, the fluctuation did not exceed 0.1 percent. The days when the fluctuation margin exceeded 0.1 percent were all concentrated after 2006. In

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[34]Guo Fenglin and Zhao Tonggang, "Zhou Xiaochuan: jinnian bupaichu kuoda huilü fudong qujian" (Zhou Xiaochuan: China is not ruling out the possibility of expanding the range of RMB exchange rate movement in this year), *Zhongguo zhengquanbao* (China Security Journal) (Beijing), March 6, 2007, A01.

[35]"The Second U.S.-China Strategic Economic Dialogue," U.S. Department of Treasury, May 23, 2007, http://www.treas.gov/press/releases/hp425.htm.

Table 3
Fluctuation Margins of RMB Exchange Rate (7/21/2005-7/20/2007)

Range	7/21/2005-12/31/2005	1/1/2006-12/31/2006	1/1/2007-7/20/2007	7/21/2005-7/20/2007
0‰-0.5‰	104 (94.5%)	140 (57.6%)	64 (48.5%)	424 (87.3%)
0.5‰-1‰	6 (5.5%)	70 (28.8%)	38 (28.8%)	
1‰-1.5‰	0 (0.0%)	25 (10.3%)	19 (14.4%)	54 (11.1%)
1.5‰-2‰	0 (0.0%)	6 (2.5%)	5 (3.8%)	
2‰-2.5‰	0 (0.0%)	1 (0.4%)	2 (1.5%)	6 (1.2%)
2.5‰-3‰	0 (0.0%)	1 (0.4%)	2 (1.5%)	
3‰+	0 (0.0%)	0 (0.0%)	2 (1.5%)	2 (0.4%)

Source: author's calculation.

2006, there were 32 trading days in total when the fluctuation exceeded 0.1 percent. Between January 1 and July 22, 2007, the fluctuation exceeded 0.1 percent on 30 trading days (see table 3).

From July 22, 2005, to March 1, 2006, the average fluctuation margin of the RMB exchange rate was 0.021 percent. From March 2 to December 31, 2006, the average was 0.055 percent, and from January 1 to July 20, 2007, it was 0.069 percent. Although on July 21, 2005, China had announced that the floating band of the RMB exchange rate would be enlarged to 0.3 percent, the band was actually far smaller than that. As the international community increased its political pressure on China, the Chinese government gradually increased the amount by which the RMB was allowed to appreciate.

Since 2007, the Chinese government has admitted that China's exchange rate policy is influenced by international political pressure, and that if China's trade surplus with the United States continued to increase, exchange rate flexibility would definitely be enhanced. In private, the Chinese government promised the U.S. government the same thing. China increased the floating band of the RMB exchange rate both in principle and in practice.

July 21, 2007 ~ July 20, 2008

The U.S. trade deficit with China in 2007 was worth US$252.6 billion, an increase of US$20.2 billion over 2006; from January to June 2008, it was US$117.5 billion, which was fair compared to the corresponding period of 2007. As of March 2008, China's foreign exchange reserves had reached US$1,682.2 billion. Between the date of China's exchange rate reform on July 21, 2005, and July 20, 2008, the RMB had appreciated by 17.51 percent. Between July 23, 2007, and July 18, 2008, the margin of RMB appreciation was about 9.8 percent.

In its public speeches and statements, the United States continued to ask China to speed up reform of its exchange rate policy. Even though compared with the initial stage of the reform, the pace and margin of RMB appreciation had speeded up since 2007, the United States did not consider the pace to be fast enough.[36]

In public, the Chinese government continued to justify China's trade surplus in terms of international comparative advantage and industrial transfer, and argued that the source of the problem was not China's exchange rate.[37] Nevertheless, on November 28, Wen Jiabao stated that China would allow the market to determine the RMB exchange rate still further and improve the RMB exchange rate regime in a proactive, manageable, and gradual manner.[38]

The United States did not accept China's explanations. On December 5, Paulson stressed that "China is reforming its policy, but the pace is still not fast enough to reduce China's global trade surplus, its internal imbalances, or foreign exchange market pressures."[39]

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[36]U.S. Department of the Treasury, "Remarks by Secretary Paulson on Managing Complexity and Establishing New Habits of Cooperation in U.S. Economic Relations at the 2007 George Bush China-U.S. Relations Conference," U.S. Department of the Treasury, October 23, 2007.

[37]People's Bank of China, "Hu Xiaolian zai renmin yinhang shiqida fudao baogaohui shang qiangdiao luoshi kexue fazhanguan cu jinguo ji shouzhi pingheng" (Hu Xiaolian emphasizes concept of scientific development and promotion of international balance of payment at the 17th conference of PBoC), November 12, 2007.

[38]"Wen Jiabao: Zhongguo jiang jixu wanshan renminbi huilü xingcheng jizhi" (Wen Jiabao: China will continue to improve RMB exchange rate formation mechanism), *Xinhuanet*, November 28, 2007, http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/newscenter/2007-11/28/content_7162876.htm.

[39]U.S. Department of the Treasury, "Remarks by Secretary Henry M. Paulson, Jr. on Main-

The U.S. treasury secretary disclosed that China agreed with the United States in closed-door talks. On December 13, 2007, during the press conference after the U.S.-China SED, Paulson said, "The Chinese recognize growing inflationary pressures in their economy and that a more flexible currency expands their ability to use monetary policy to stabilize their economy."[40]

A couple of days later, in its report to Congress on the international economy and exchange rate policy, the U.S. Treasury reiterated that what China was doing could not be classified as manipulation, but the problems of the imbalance of the Chinese domestic and external economy, inflation, and increasing domestic liquidity were all caused by the RMB exchange rate. The report emphasized that the solution to these problems would be the accelerated appreciation of the RMB effective exchange rate.[41] On March 6, 2008, Zhou Xiaochuan confirmed that RMB exchange rate flexibility would be expanded gradually from then on, and that the fluctuation margin would depend more on market forces.[42]

As the margin of RMB exchange rate appreciation increased in 2008, the bilateral post-meeting communiqué of the fourth meeting of the U.S.-China SED on June 18, 2008, stated that "the RMB has appreciated 20.3% since exchange rate regime reform against the U.S. dollar in July 2005, the annual pace of appreciation has accelerated to 14.6% compared to 3.4% in 2006 and 6.9% in 2007."[43] It seemed that the United States was satisfied with this result and did not propose further reform of the RMB exchange rate.

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taining Forward Momentum in U.S.-China Economic Relations before the Asia Society," U.S. Department of the Treasury, December 5, 2007.

[40]U.S. Department of the Treasury, "Transcript of U.S. Delegation Press Conference: Third Meeting of the U.S.-China Strategic Economic Dialogue," U.S. Department of the Treasury, December 13, 2007.

[41]U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," U.S. Department of the Treasury, December 19, 2007.

[42]People's Bank of China, "Ma Kai, Xie Xuren, Zhou Xaiochuan jiu jingji shehui fazhan he hongguan tiaokong deng dawen" (Ma Kai, Xie Xuren, and Zhou Xiaochuan answer questions about economic social development and macro control policy), March 6, 2008.

[43]U.S. Treasury Department Office of Public Affairs, "U.S. Fact Sheet: Fourth Cabinet-Level Meeting of the U.S.-China Strategic Economic Dialogue," U.S. Department of Treasury, June 18, 2008.

In the MPR for the fourth quarter of 2007, the PBoC continued to stress that measures would be taken to increase the flexibility of the RMB exchange rate. In the MPR for the first quarter of 2008, the PBoC stressed that the channels for capital outflow would be enlarged in sequence, with the goal of balancing the international balance of payments. In the MPR for the following quarter, in addition to continuing to pursue the policy goals of the previous MPR, the PBoC stated that formation of the RMB exchange rate should be further subject to market supply and demand.

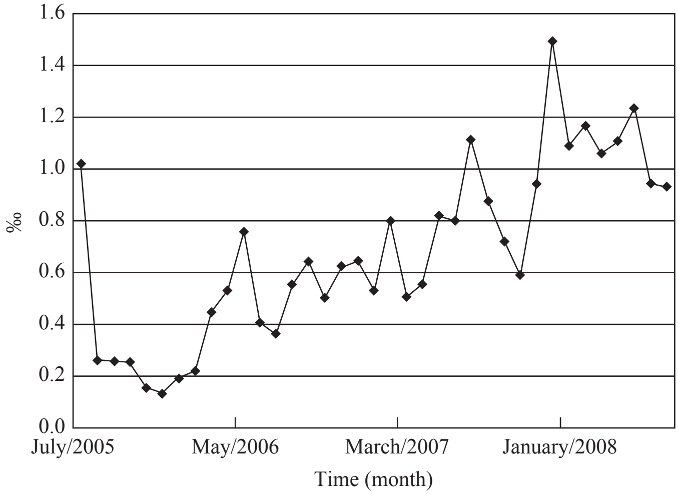
From July 21, 2007, to July 20, 2008, the margin of RMB exchange rate appreciation had increased substantially. From July 22, 2005, to July 20, 2006, the RMB appreciated by about only 1.5 percent. Appreciation increased to around 5.2 percent between July 21, 2006, and July 20, 2007; and from July 21, 2007, to July 20, 2008, it appreciated by 9.8 percent. In addition, the RMB's floating band also expanded, with the average fluctuation margin increased from 0.021 percent from July 22, 2005, to March 1, 2006; to 0.055 percent from March 2, 2006, to December 31, 2006; 0.069 percent from January 1, 2007, to July 20, 2007; and to 0.105 percent from July 21, 2007, to July 20, 2008 (see figure 1).

Although on public occasions the Chinese government still maintained that China's trade surplus was not the result of an undervalued RMB, in closed-door talks with the United States it agreed with Washington about the need for exchange rate reform. Meanwhile, in the period 2007-08, China speeded up the pace of this reform.

Discussion

From the perspective of either internal or external economic balance, China did not experience significant pressure to revalue the RMB during the period 2003-07, but nevertheless, China did carry out reform of its exchange rate regime and revalue the RMB. In contrast, China experienced no less economic pressure to revalue in 2008-11, but the RMB exchange rate remained relatively stable. It is clear for the reasons given

Figure 1
Average Movement of RMB Exchange Rate



Source: Author's calculation.

below that international political pressure was one significant factor behind China's exchange rate reform.

First, inflation is a good indicator for observing economic pressure on currency appreciation.[44] China's average inflation rate was 2.3 percent between 2003 and 2005 and it was 1.8 percent in 2005 when the RMB exchange rate reform took place. The average inflation rate was 3.2 percent between 2006 and 2007. There was no pressing economic reason for China to revalue the RMB and reform its exchange rate regime between 2003 and 2007. In particular, there was no clear inflation pressure on

[44] Noer Azam Achsani, Arie Jayanthy F A Fauzi, and Piter Abdullah, "The Relationship between Inflation and Real Exchange Rate: Comparative Study between ASEAN+3, the EU and North America," *European Journal of Economics, Finance and Administrative Sciences*, no. 18 (2010): 69-76; Sebastian Edwards, "The Relationship between Exchange Rates and Inflation Targeting Revisited," *NBER Working Paper Series*, no. 12163 (April 2006): 1-45; Glenville Rawlins, "The Exchange Rate-Inflation Link: The Experience of Some Caribbean and Central American Countries," *Journal of Applied Business and Economics* 8, no. 1 (2008): 9-26.

Table 4
China's Consumer Price Index, 2000-2012

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
CPI	0.4	0.7	-0.8	1.2	3.9	1.8	1.5	4.8	5.9	-0.7	3.3	5.4	2.6

Source: National Bureau of Statistics of China, http://www.stats.gov.cn/tjsj/ndsj/2011/indexch.htm; http://www.stats.gov.cn/tjfx/jdfx/t20130111_402865500.htm (accessed January 13, 2013).

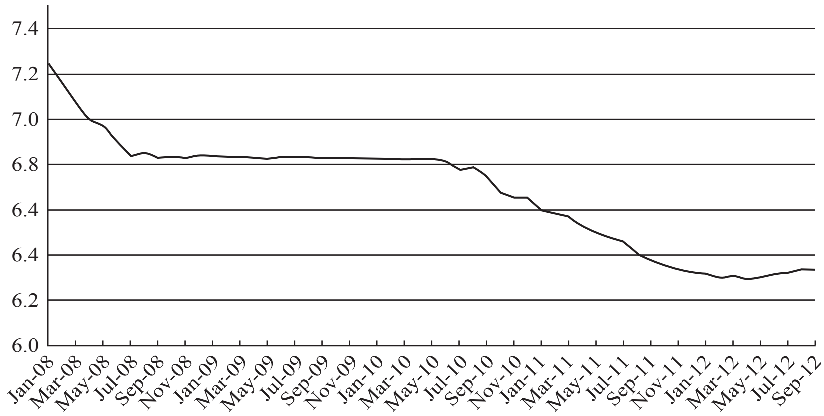
China to reform its exchange rate policy in July 2005 (see table 4).

Second, the Chinese government argued that the RMB was not undervalued in early 2005 in terms of maintaining the balance of payments. According to Zhou Xiaochuan, China's current account was basically balanced, or even in surplus, yet exchange rate reform was carried out in July 2005.

Third, the RMB exchange rate was relatively stable between July 2008 and July 2010, given China's relatively high inflation rate of 5.9 percent in 2008 and its rapid accumulation of foreign exchange reserves between 2008 and 2010. China accumulated an average of US$440 billion annually between 2008 and 2010, compared to the average of US$248 billion accumulated in 2003-07. The RMB began to appreciate in August 2010, despite the fact that China's inflation rate was only 3.3 percent that year. By contrast, with inflation at 5.4 percent, the pace of RMB appreciation decelerated in the second half of 2011. It seems that inflation and external economic balance were not sufficient to explain China's exchange rate policy during 2008-12 (see figures 2 and 3).

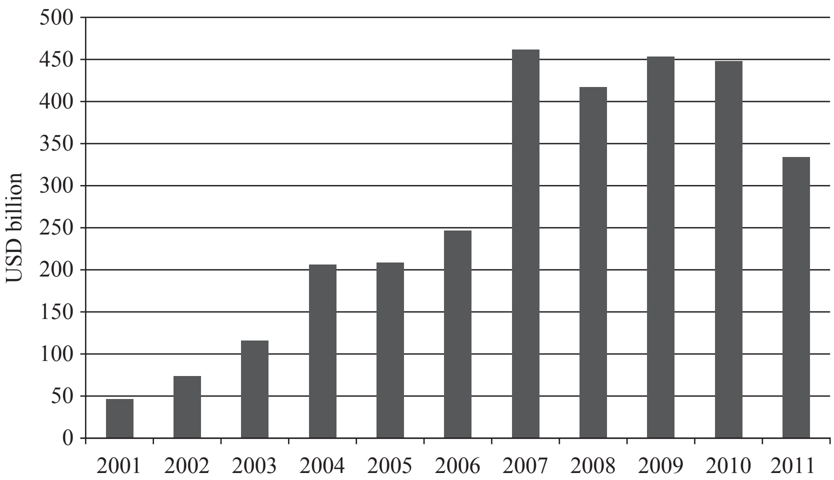
Fourth, the Chinese government may have cited economic reasons (such as the need to combat inflation or maintain the balance of payments) for revaluing the RMB partly to disguise the fact that they were succumbing to international political pressure. For instance, in a speech delivered on November 4, 2005, Zhou Xiaochuan insisted that there was sufficient flexibility in China's economy to adjust the RMB exchange rate more freely according to an appropriate economic model. Here, Zhou was using economic reasons to rationalize a possible increase in exchange rate flexibility for fear that others might think the Chinese government was susceptible to international political pressure.

Figure 2
Variation of RMB Exchange Rate: 2008-2012



Source: People's Bank of China: http://www.pbc.gov.cn/.

Figure 3
China's Foreign Exchange Reserves



Source: China's State Administration of Foreign Exchange, http://www.safe.gov.cn (accessed on January 13, 2013).

Fifth, in its public statements from 2002 to early 2003, the Chinese government resolutely insisted that international political pressure would not force it to adjust the RMB exchange rate. However, since early 2005, the Chinese government has been prepared to admit that pressure to adjust the RMB exchange rate was not coming solely from the economy; international political pressure was also a factor.

Finally, along with subsequent policy measures, rhetoric did matter in China's policy explanations and credibility. Based on evidence contained in China's official policy documents, statements made by Chinese and U.S. officials after their bilateral talks, testimony given by U.S. officials to Congress, and the Chinese government's actual policies and deeds (such as dispatching "shopping groups" to the United States to purchase American products, and extending invitations to U.S. congressmen who had criticized China's exchange rate policy) between 2003 and 2008, the Chinese government's exchange rate policy was influenced not only by economic and domestic factors, but also by political pressure from the United States.

Conclusions

This paper does not discount economic reasons for reform of the RMB exchange rate regime and the appreciation of the RMB. However, there were no significant and pressing economic reasons (such as inflation or the need to maintain the balance of payments) for the Chinese government to revalue the RMB and reform the exchange rate regime between 2003 and 2008. Despite the lack of any pressing need to balance the economy either internally or externally, in 2003-08, China reformed its exchange rate regime and revalued the RMB. In 2008-11, although it was under no less economic pressure to let the RMB appreciate, China maintained a relatively stable exchange rate.

International political pressure provides one significant explanation for China's exchange rate reform. Based upon China's public statements, Sino-U.S. communiqués, U.S. official testimony to Congress, and China's subsequent policy measures between 2003 and 2008, our finding is that

China's exchange rate policy was influenced not only by economic and domestic factors but also by political pressure from the United States.

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