

## THE STORY OF EXCHANGE RATE MOVEMENT BY CHINA AND ITS IMPACT ON USA ECONOMY

**Muhammad Akram**

*Hailey College of Commerce, Faculty of Commerce  
University of the Punjab, Lahore – Pakistan  
makram.hcc.pu.edu.pk@gmail.com*

**Muhammad Ramzan**

*Hailey College of Commerce, Faculty of Commerce  
University of the Punjab, Lahore – Pakistan  
ramzan.hccpu@yahoo.com*

**Sundus Naveed**

*Hailey College of Commerce, University of the Punjab, Lahore – Pakistan*

**&**

**Saira Hameed**

*Hailey College of Commerce, University of the Punjab, Lahore - Pakistan*

### ABSTRACT

*Exchange rate is an important element of the country's economic health. It is one of the most scrutinized, anatomized and manipulated economic dimension. The purpose of this study is to examine the impact of exchange rate of China on the US trade, employment and on its currency as well. The approach to this paper is to answer the questions such as the mechanism selected by China for its exchange rate determination? What are the interests of China in adopting the fixed exchange rate strategy? How this step of China is affecting the U.S.? What steps are taken by US to abandon China's policy? This paper concludes that US economy is badly affected; China snatches the jobs of US, exports of China rushes towards US economy while imports from US towards China did not come with that pace. This happens because of exchange rate and trade mechanism adopted by China. Moreover this policy of China is beneficial for its economy but not for the well being of the Chinese people. This paper is beneficial for the researchers, students, policy makers, politicians and economists related to international finance area.*

**Keywords:** *US dollar, China, Yuan, Fixed Exchange Rate, Floating Exchange Rate, Trade Deficit.*

### 1. INTRODUCTION

Currency war between the countries is not that new. Countries use to change their strategies regarding the management of the exchange rates, and adopt those which are in their interests. Developing nations use the strategy of devaluation of their currencies, by this they gain the exports and generate income for their country. These sorts of practices are also termed as manipulations even. Corden (2009) stated that countries try to manipulate their currencies in order to get control over their economy. However, these types of practices are hindrance in the way of fair play between the countries and their economies disturbed to the greatest extent by these practices. China and USA are two strong economies and have good relationships between the two countries are important not only for them but also for the economic growth of the rest of the world. China adopted fixed exchange rate mechanism. Devaluation in the currency of China has boosted its exports to larger extent. Everything was going good until the impact of this devaluation begins to affect the US economy. Jobs flew away from US economy towards China. The Chinese government is managing the exchange rate mechanism and trade. This led US to lose millions and millions of dollars. Dual deficit was being faced by US and China is having a surplus balance. This condition is

not favorable for US; China is being forced to appreciate its currency. As the most important role playing factor of inappropriate relationship is exchange rate crisis (Parsad, 2009). As the importance of China's economy is increasing day by day so is its importance among its trade partners. So, the undervaluation of the Yuan is burning issue in world economy and 29 academic papers were dealing with this issue written by Korhonen and Ritola (2009) only. Numbers of researchers do call for the flexibility of the exchange rate system in their studies (Goldstein and Lardy 2004; Roubini & Setser 2005; and Eichengreen 2004). This exchange rate war between China and US has originated various questions to be answered. Some of the major questions are being sought to be answered in this study.

### 1.1 Research Questions

Following questions are being dealt in this study

**RQ1:** What is the exchange rate strategy being adopted by China?

**RQ2:** What are the interests of China behind its adherence to fixed exchange rate?

**RQ3:** What is the impact of devaluation of the Yuan on US exports, imports and jobs?

**RQ4:** What steps are being taken by US in this regard to protect its interests from the impact of Yuan?

### 1.2 Exchange rate mechanism adopted by China

Since 1978, China has made adjustments in the exchange rates. McKinnon et al. (2008) has divided the policies of China into three phases

- Phase 1: (before 1994): currency inconvertibility stage.
- Phase2: (1995-2005): fixed exchange rate against dollar.
- Phase 3: (2006 to till now): forecasted upward trend.

However, the table below clearly depicts the strategies being adopted by China regarding its exchange rate.

**Table 01: Exchange Rate Mechanism by China**

Years	Mechanism adopted by China
Until 1978	Fixed exchange rate
1978-1980	China changed its system of strict exchange rate policy and adopted dual exchange rate system. Later changed it with strict pegged US dollar by managing the float.
1981-1986	Managed a fixed exchange rate against the basket of currencies.
1986-1994	Yuan was fixed once again against dollar, 8.6 per dollar initially.
1994-1996	Appreciation in value of Yuan occurred due to increase in productivity and GDP.
1996	Yuan got devalued
2001	Pegged in a narrow range i.e. 8.28 per dollar.
2005	Floating exchange rate was established which results in appreciation of value by 2.1% i.e. 8.28 to dollar
2006-2007	Appreciation of 6.5 % was recorded i.e. 7.73 per\$.(27 <sup>th</sup> April 2007)
2008	Value increased by 20% which is 6.83 Yuan for 1\$(Yuan strengthen over time)
2009	Value of Yuan was 8.5 Yuan for 1 \$ (July)
2010, June	6.8275 Yuan to 1 US \$,reached to highest level against dollar after 2008
2011 Jan	6.62 Yuan to 1 US \$

Source: Authors' own compilation

Table 01 clearly depicts the strategies being adopted by China. Mostly the fixed exchange rate is managed with the appreciation or depreciation of its value from time to time. In spite of these minor alterations, move towards Yuan appreciation is too slow. China is not allowing its exchange rate to be determined on the demand and supply mechanism.

China has been maintaining a pegged against the US dollar but on 21<sup>st</sup> July 2005, People's Bank of China made exchange a bit flexible and a little appreciation was recorded to 2.1%. Though this new rule regarding the exchange rate policy of China was based on the currency basket rather than pegged against US dollar mere. But the results were extremely opposite as the secret basket of currency leads the US dollar to appreciate. Even before the financial crises of 2008 the dollar received the higher weight as compare to the other currency basket in China's exchange rate policy (Fidrmuc, 2010).

The continuous increase in the dollar shows that this new regime was running on the old policy of pegged against US dollar and it is empirically proved in number of research studies like Frankel (2006) and Funke & Gronwald (2008). However till July 2008, China appreciated to 20% within three years between 2005-2008, still China's currency remains significantly undervalued from 20%-30%, countries adhere to fixed exchange rate usually due to the fear of floating mechanism (Calvo & Reinhart, 2002). China is also having this fear that floating exchange rate may curtail its exports, and it is natural to protect country's own interests first in various ways and exchange rate determination is one of these ways.

### 1.3 Interests of China

Fixed exchange rate helps China to devalue its currency. Devaluation always comes with some blessings, among some of them China is availing. Devaluation of Yuan increases exports, foreign reserves, gross domestic product and debt servicing. Hence a positive flow of money to China. Devaluation might be a blessing for one country, but it can affect the rest, regarding their growth. China's main focus is to keep Yuan devalued against dollar. This strategy of China awards it with the trade surplus, thus rising exports over imports which lead to accumulation of US reserves. As during the period 2005-2008, China accumulated reserves of 1.9 trillion US dollar which equals to 20% of public debt of US (Christopher, 2009). Foreign reserves of China increased up to 2.4 trillion by 2009 (Luk 2010) of which 70% are US dollars (Chinability 2010). China is maintaining the peg against US for which China has to purchased US treasury bills and other securities of about \$ 200 billion (in 2006) and \$ 453 billion US dollars in 2008-2009. This makes the currency of China cheap and subsidy is being gained by China on its exports (AFL-CIO 2006). Though China is keeping the US treasury bills but US is generating the fruitful returns on this. As Chinese investors want to invest in the US bonds in spite of the fact that US bonds are providing fewer yields, while US investors enjoy higher return. (Pierre & Helene, 2005).

## 2. IMPACT ON US

After becoming the member of WTO in 2001 China gained a great focus from rest of the world regarding its massive productivity. This helped China to increase its export to large extent (Luk, 2010). Entrance into the WTO of China was once regarded as win-win strategy by US president, was no more a win-win game. If the value of Yuan is determined by the demand and supply mechanism, then its value would be relatively higher than the original fixed rate which the China is maintaining. Thus exports of China raised to large extent, even the USA, become the market of China due to its cheap exports.

### 2.1 Impact on the exports and the imports of USA

This table is depicting the details of the US exports to China and US imports from China from 2001-2010.

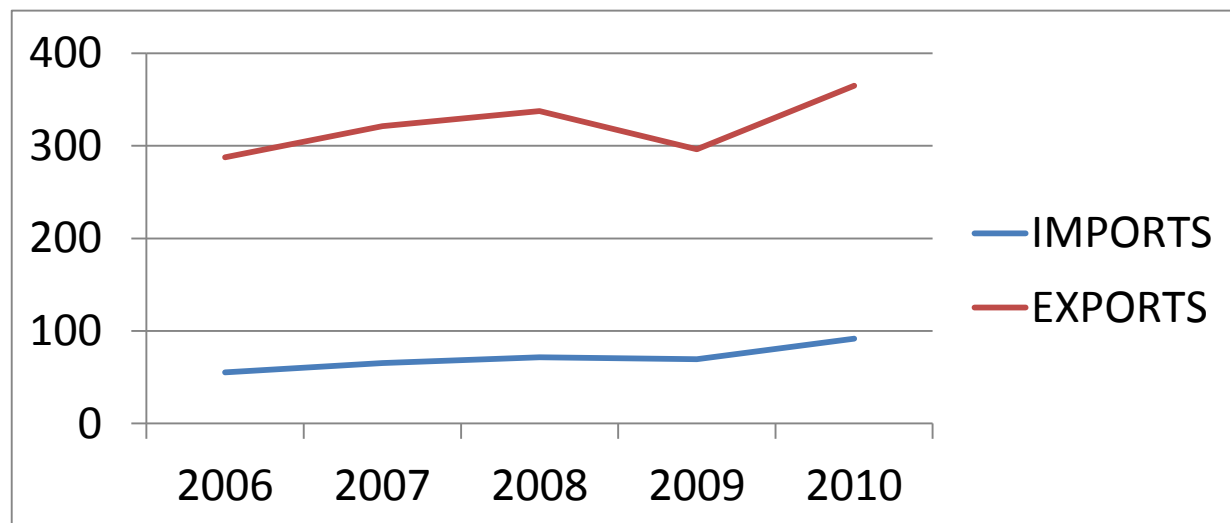
**Table 02: US Trade with China, 2001-2010 (in \$ billion)**

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
US (exports to China)	19.2	22.1	28.4	34.7	41.8	55.2	65.2	71.5	69.6	91.6
US (imports from China)	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8	296.4	364.9
US balance	(83.0)	(103.1)	(102.0)	(162.0)	(201.6)	(232.5)	(256.3)	(266.3)	(226.8)	(273.1)

\* Source: US Department of Commerce (2001-2011), US International trade Commission (ITC)

US exports to China are less in past in past ten years as compare to its imports to China. But every coming year bring increase in the exports when compared with the previous year.

**Figure 01: US Imports and Exports (2006-2010)**



Source: US Department of Commerce, (2006-2011), US International trade Commission (ITC)

From 1985-2010 a roughly increase of 2500% of imports from US in 15 years i.e. from \$ 3.9 billion to \$ 92 billion was recorded. While on the other hand China's export to US increased from \$ 3.8 billion to \$ 365 billion during this period which is roughly an increase of 10000% certainly a real gain.

2011 comes with the same trend, with increase in the exports is also recorded. But overall deficit still prevails in market.

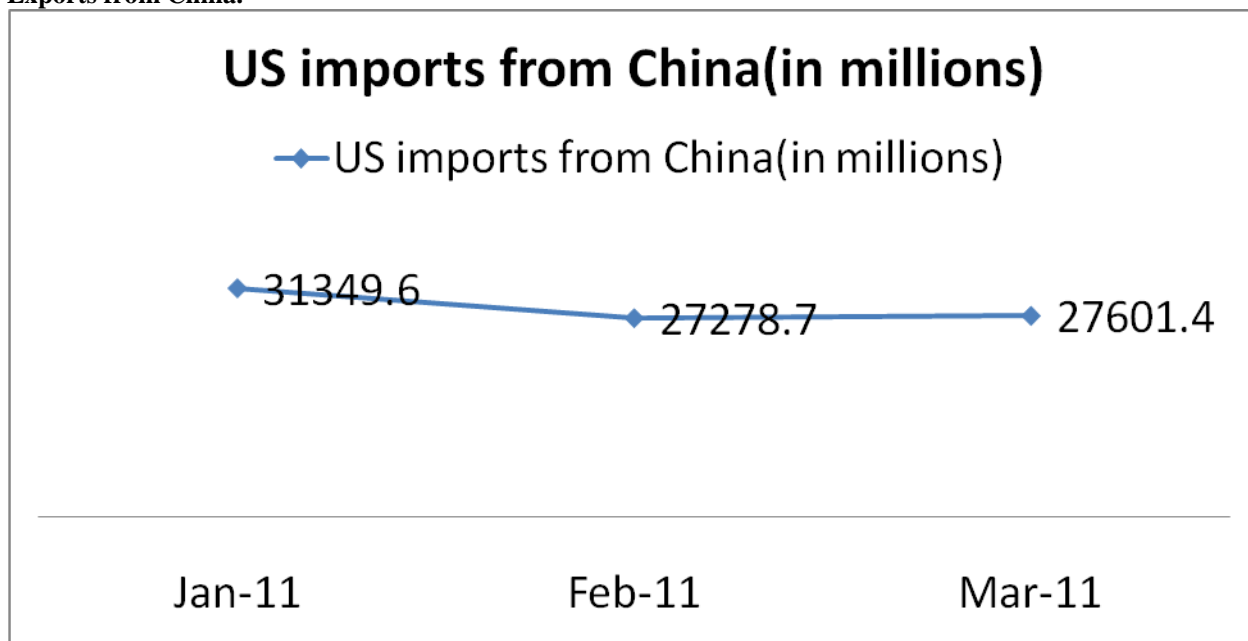
**Figure 02: US Trade with China, Very recent trends: US Exports to China are increasing.**



Source: US Department of Commerce, (2011), US International trade Commission (ITC)

China's policy of undervaluation of its currency, Provision of subsidies on its exports to US and making imports more expensive, took the market share in world trade away from US.

**Figure 03: US Trade with China, Very recent Trends: US Imports from China are not equivalent to the Exports from China.**



Source: US Department of Commerce, (2011), US International trade Commission (ITC)

As the consumption pattern in US is more than its production. Due to this US has to import the things from the rest of the world. China gets advantage in this regard because of its cheap goods. USA is gaining day by day imports from China. Among the trade partners of China, USA is on the top. However, 2011 comes with the positive trend for US as imports from China declines.

**Table 03:**

**China's top trade partners  
2010(\$ billions)**

Ranking	Country	Volume
1.	USA	385.3
2.	Japan	297.8
3.	Hong Kong	230.6
4.	South Korea	207.2
5.	Taiwan	145.4

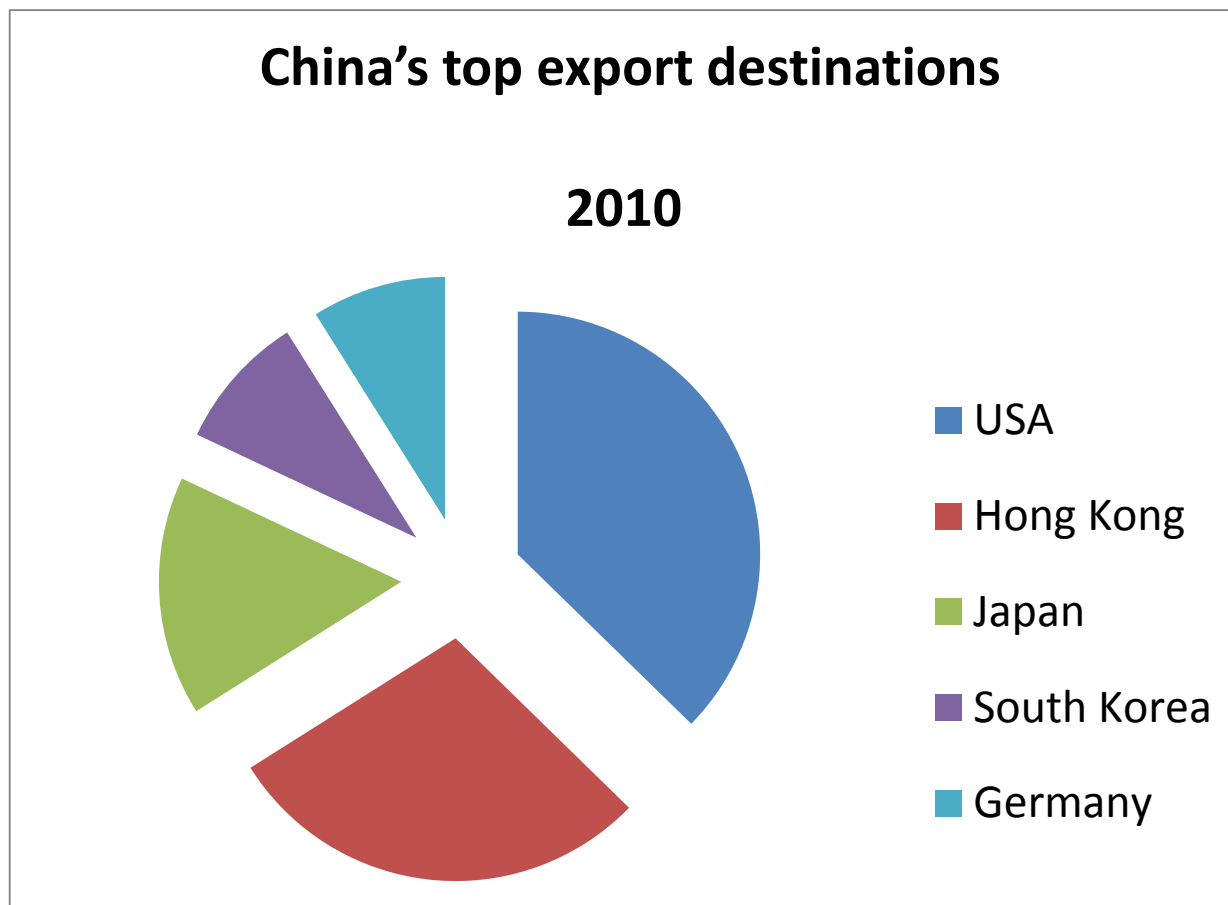
Source: US Department of Commerce, (2011), US International trade Commission (ITC)

**Table 04:**

**China's top export destinations  
2010 (\$ billions)**

Ranking	Country	Volume
1.	USA	283.3
2.	Hong Kong	218.3
3.	Japan	121.1
4.	South Korea	68.8
5.	Germany	68.0

Source: China's customs statistics PRC General Administration of Customs, (2010).

**Figure 04: Destinations of China's Exports**

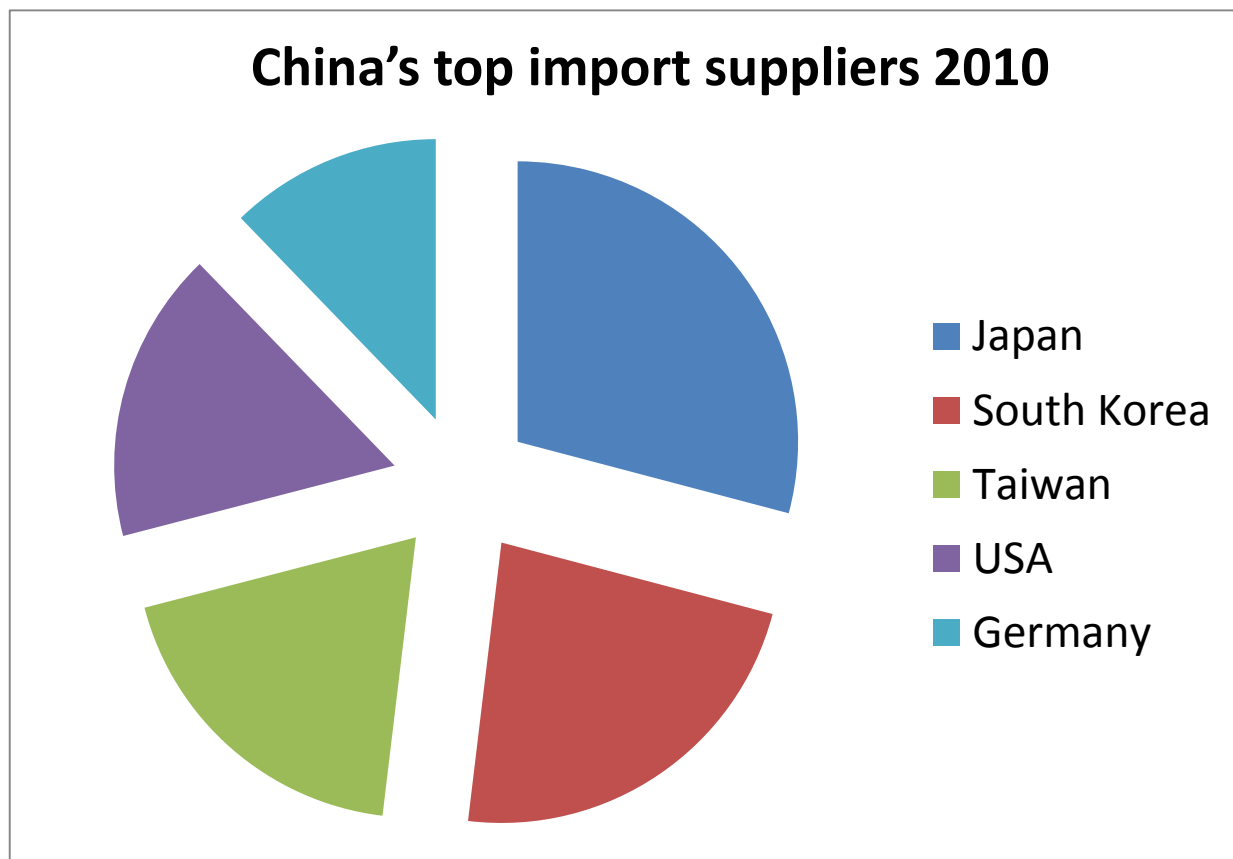
Source: China's customs statistics PRC General Administration of Customs, (2010).

Among the China's export destinations, USA is the top priority of China. More and more exports are moving from China to the US economy which leads the sectors of the US particularly the manufacturing sector to suffer a lot. Cheap products of China are gaining their market in the US economy and it had disturbed the local production activities to great extent.

**Table 05:**

China's top import suppliers 2010(\$ billions)		
Ranking	Country	Volume
1.	Japan	176.7
2.	South Korea	138.4
3.	Taiwan	115.7
4.	USA	102.0
5.	Germany	74.3

Source: China's customs statistics PRC General Administration of Customs, (2010).

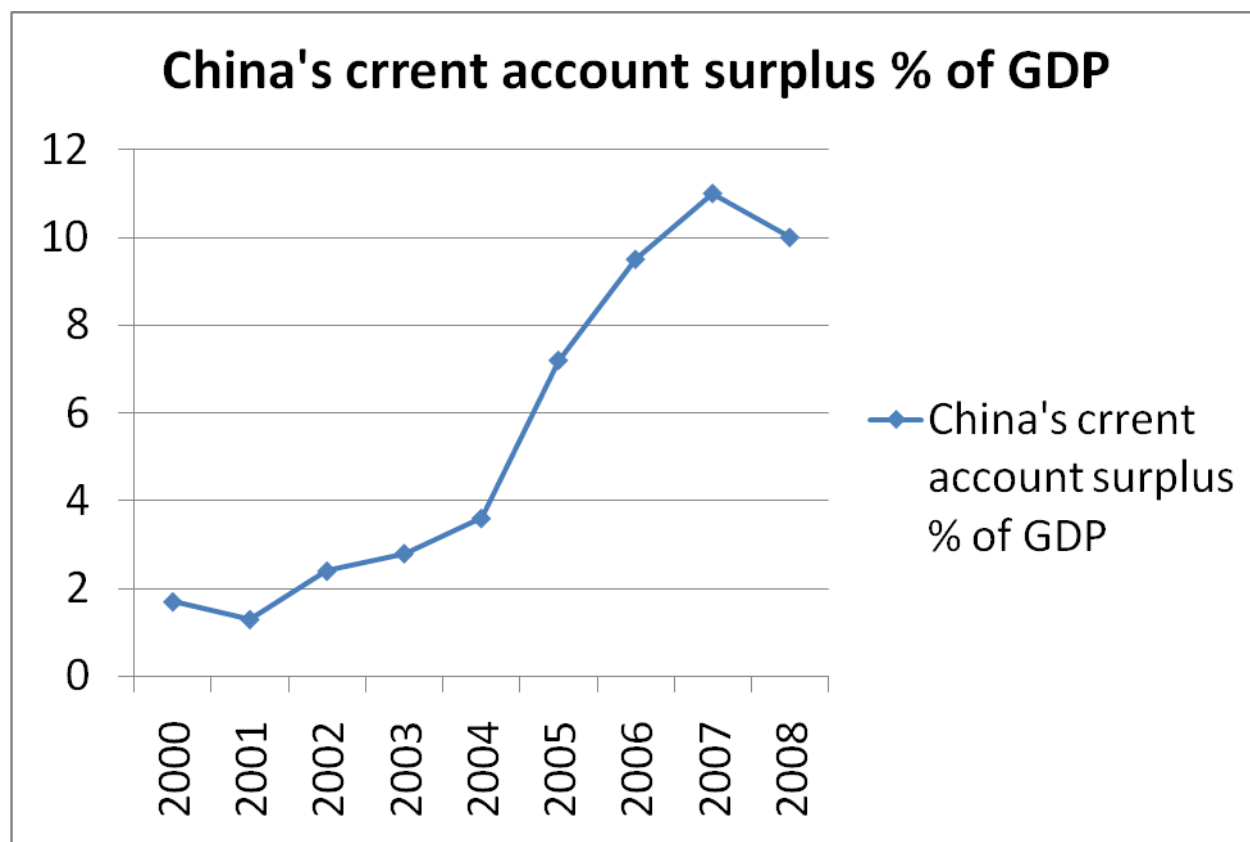
**Figure 05: Major Suppliers for China**

Source: China's customs statistics PRC General Administration of Customs, (2010).

These tables show that among the five top countries towards which China is channelizing its exports, US stood at the top. While among the importing countries US ranked the 4<sup>th</sup>. This is because of China's cheap products, less expensive labour, undervaluation of its currency. China subsidized its exports to US of round about 40% of US dollars (cline and Williamson 2010) and makes imports more expensive.

On the other hand China is having trade surplus. As from 2005-2008 China made a trade surplus of 17.5 billion US dollars (Herrmann 2010.p31-51) but this reduced from 10.6% of GDP to 5.2% of GDP (2007-2010).

This occurred due to decline in exports as recently rich economies are facing recession. In China the industry and the urban region is developing (Bussière et. al., 2008), growth rate is increasing due to high exports and foreign investment. (Eichengreen & Tong, 2005). The growth in China changes the economic distributions across the world and it is affecting the economy of the rest of the world. Chinese's GDP contribution in the rest of the world increased from 1.7 percent to 7.2 percent (1980 to 2008). \*OECD

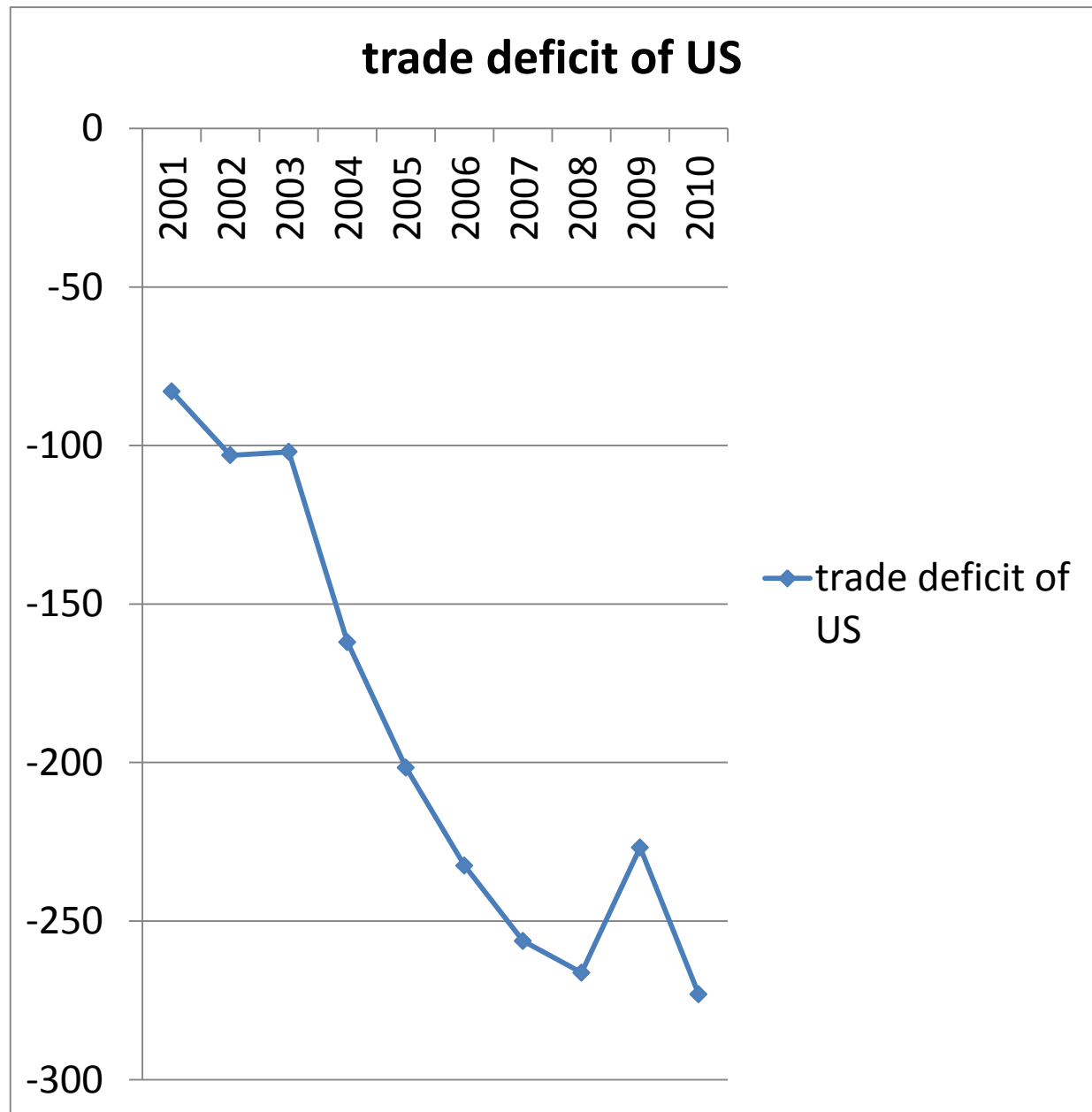
**Figure 06: China's current account surplus as percentage of GDP from 2001-2008**

Source: International Monetary Fund, *World Economic Outlook*, April 2009.

\* 2010: OECD Economic Survey China, OECD, Paris.

Call was being made by US to reduce the current account deficit to 2.8% of GDP till 2012. Many Asian countries which are undervalued with respect to US are joining hands to help the US by adjusting the value of their currency against US. So that US can come out of its trade deficit while China is still exhibiting the fixed exchange rate which may lead to more deficit for US and weakens its currency. US trade deficit in 2001 was \$ 84 billion and in 2008 it was \$ 270 billion. However the good trade deficit of US declines from 38.5%-15.4 % ( 2008-2009), US-China non oil trade deficit increases from 68.6%-82.2 % ( Scott 2010). Trade deficit in March 2011 was \$ 42.8 billion largest discrepancy in 12 months. China has adopted the rules of dumping and providing subsidies on exports, due to which US economy is facing these deficits.

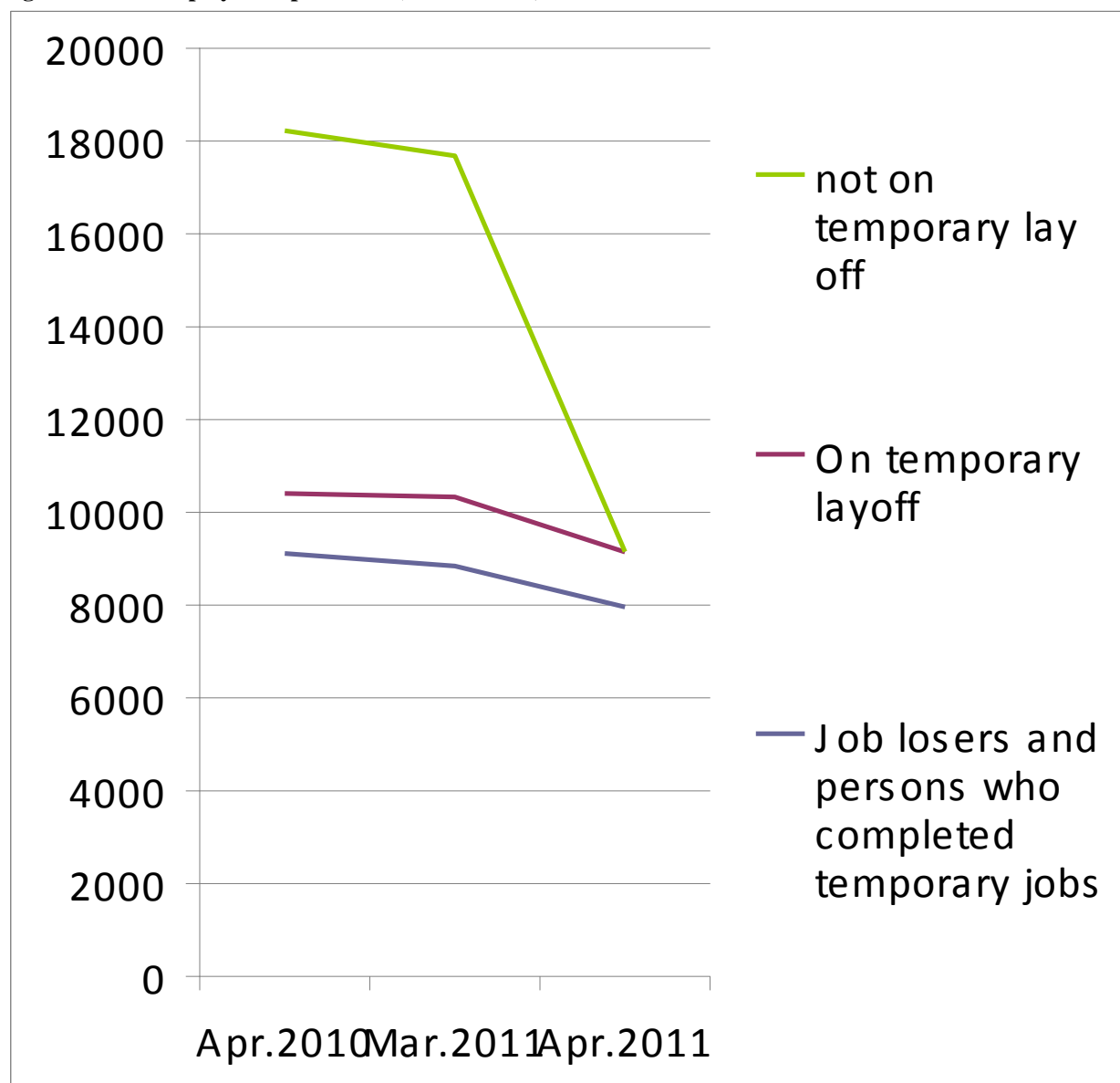


**Figure 07: US Trade Deficit (2001-2010)**

Source: US Department of Commerce (2010), US international trade commission (ITC)

## 2.2 Impact on jobs

It has been estimated that, from 2001 since the entry of China in WTO 1.6 millions of jobs of have been lost, because production moved to China, between (1997-2006) unemployment increased, as previously it was supporting 2166000 US jobs. Upward trend was recorded in the number of people unemployed in USA after 2001.

**Figure 08: Unemployed Population (in thousands).**

Source: Economic News Release (Bureau of labor statistics) of US (2011)

This table shows that 8519 people lost their jobs and the persons who have completed their jobs temporarily accounts for 60% of the total people employed. 5789 jobs were lost permanently by January 2011. However unemployment is falling from 2010-2011 but as the recession is prevailing it might go up in future.

**Table 06: Number of jobs lost in USA (2001-2008)**

Sector	Number of jobs lost
Manufacturing sector	1616300
Electric sector	627700
Administration and support service industry	153300
Professional, scientific and technical services	139000

Source: Economic News Release (Bureau of labor statistics) of US (2011)

Unemployment was 9% in January 2011 (Bureau of Labor Statistics US). Labor of China is cheap in comparison to US, and companies in the US have to pay high taxes, moreover high inflation rate is prevailing in US as it was 1.6% in January 2011. So they move towards the other countries. Most of the firms of US even move their FDI in China, or they avail the facilities of cheap labor. This condition was devastating for the Americans. Decline in the wages of the workforce was recorded. Number of jobs lost in different sectors of the US depicts that highest jobs flew away from the electric sector. The manufacturing sector of the US is also lagging behind, as manufacturing operations are moving overseas due to low work force cost there.

2.4 million Jobs lost in manufacturing sector of the US from 2001-2008. The free trade eliminated jobs in US and the wages of the 100 million workforces also decline. Foreign firms for the Americans conducting business in China are facing problem because the nuclear rules are present for the intellectual properties and the Chinese used to prefer state owned firms over the rest. China also claimed to charge high taxes on their fabric products and services to Europe and US. USA is facing a lot of problems in the manufacturing sector. It has been reported by the CEO'S of the firms in New York that US production is less, as compare to the production of China. As the labor available in China is cheap, this is the key constraint for the US economy.

### **3: USA IS FORCING CHINA TO SWITCH ITS EXCHANGE MECHANISM FROM FIXED TO FLOATING**

To reduce this issue, USA is forcing China to get considerable measures to appreciate its currency. And for proper revaluation of Yuan the appreciation is the main step (Goldstein and Lardy 2003b) and it should not be a slow process (Kroeber 2007, Goldstein and Lardy 2003a, 2003b, 2005). As the value of Yuan has been settled 25%-40% lower as compare to US. So China have to appreciate her currency from 20%-40%, which would result in the depreciation of the US dollar from 20%-40%. If China kept on showing this behavior persistently regarding the floating exchange rate system it would have effect on the global exchange rate system's operations and on the policy of other currencies and on the trade activities of the world. It would adversely affect the market of US, Japan and Europe (Goldstein 2007). USA is also taking help of the IMF and WTO in this regard. If China would not appreciate its currency WTO will pass the order to US to increase the excise duties on products imported from China.

#### **3.1 View of China in this regard**

While China is of the view if she appreciate her currency it would lead to high unemployment, fragile banking system of China does not allow this and exports will no longer be the same. (Roubini, 2007). China is having the world largest population. Cheap labor results in the maximum production of goods; here the devaluation of currency works to let the products sold on cheaper rates. Appreciation of Yuan would decrease the demand of these products. As people buy Chinese products because they are cheap. Management of the exchange rate of the China is being declared as the manipulation by the rest of the world, while the economist Fan Gang said that the country which is having the surplus is termed as manipulator instead of the country which is running deficit and printing the money which is kept as reserves by the rest of the world. Why the countries who just accept this money are termed as manipulator? After the financial crises of the US it was commented in the Chinese news paper people's daily (official newspaper of the Chinese communist party) that world should have to adopt the financial system and order which should be fair and should be independent from United States. (Chin and helleiner, 2008)

### **4: CRITICISM ON THIS APPROACH OF CHINA BY USA**

Fixed exchange rate which is being adopted by China is altering the mechanism of the markets. Though this helps to increase the exports, but people of other nations inclined to buy it not because of their quality mostly but because of their less cost. So China is keeping its goods artificially cheap, which is despicable for the foreign competitors. Different nations of the world are of the view that they still do not find any such method to letting countries stop from increasing their trade by interference in the exchange rate mechanism. USA is of the view that China should

let market forces to determine the exchange rate of country, but Kaltsky, (2010) is of the view that if the market forces did not help the credit crunch in US to abolish, how it can be able to provide employment and reduce the deficit.

#### **4.1 Would this strategy of China is beneficial for its people?**

Recent strategy of China lead her to the massive foreign reserves, which if otherwise can be invested to the education, healthcare and for the civil welfare purposes. From this strategy of China the common people of China suffers. It depicts that China do not want to take appropriate step to strengthen its banking sector. Inflation is expected to rise in the upcoming 20 years. So, investors of the China have to purchase the securities on premium and the return they are having is in dollar (of lower value). But this strategy is in their national interest which comes first.

### **5. CONCLUSIONS**

Devaluation of the Yuan with respect to US dollar is the burning issue. China's policy of pegging against the US dollar in the name of the currency basket is widely criticized. But at the same time countries are free to adopt the currencies which they consider suitable according to their economy and it is the financial freedom and right of any nation like human rights. Developing nations also used to manage their currencies under such mechanism. If it is not acceptable by other developed nations then they should have to design the rules to abandon it without forgetting that the strategies of the developed and developing nations might contradict. From US view point, appreciation in the Yuan is necessary to prevent the dollar to crash. Sudden appreciation in the Yuan is not possible due to integrated financial sector; recently China is considering the appreciation of the Yuan which is good indicator.

This paper concludes that China is getting much advantage in the trade and trade balance of US is being disturbed.

Following are the suggestions in this regard.

- China has decided to invest 1-2 trillion US dollars in FDI in US. This would create jobs for the Americans. US should welcome the Chinese firms. These types of decisions should be encouraged.
- US must have to pay attention on its manufacturing sector so that products can be produced with efficiency which would also creates jobs for U.S., increases its exports and reduces imports of these products.
- People of US must cultivate the habit of using home products to help the economy to stable.
- US should welcome the FDI in the country with major liberal policy, which would raise the employment level.

#### **5.1 Policy implications**

- Policies regarding the trade and exchange rates should be revised. IMF should have to set the standards regarding the exchange rate mechanism. Clear statement of activities regarding the exchange rate mechanism which are considered malpractices or rendered as manipulation should be stated.
- "Policy making and defining" brings nothing; it is the implementation of the rules which make the difference. So, after making the rules or steps to avoid unfair practices, IMF should work towards its implementation.
- WTO should stop the activities which are hindrances in the free trade mechanism. If the countries are unfairly subsidizing and dumping the products. Why WTO is a silent viewer then?
- Though Yuan devaluation is disturbing US economy, blaming China all the time for the deficits is not the good strategy. Because by doing so other factors prevailing in the country are badly ignored. US should strengthen its manufacturing sector.
- China should consider the appreciation in its currency, and work with US to overcome the discrepancies between them, but at the same time China must remain focus on its national financial interest.

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