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China and the Yuan: An Account of Its Trade Success and Currency Policy

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Abstract

This paper will specifically focus on the Chinese currency system and the extent to which it affects the U.S trade imbalances and monetary challenges. The aim here is to contribute to the study of China's trade success through the lens of its unique exchange rate system and management and to make a case for the undervaluation of their currency, the Yuan. More broadly, this paper will give the necessary information and tools to better understand what drives China and how to better apprehend what lies ahead. The first section will explore the main features of their system with an overview of the currency's exchange rate and trade growth, while the second part will take a closer look at the degree to which their currency policy affects the USD economy and its internal markets. The last section will attempt to give an interpretation of what challenges await China.

Keywords: exchange rate system, currency system, interdependence, trade, appreciation, undervaluation, peg, current account, deficit, trade surplus, debt

Introduction

Since Donald Trump's presidency and his 'America first' policy, China and the U.S have been engaged in a trade war that has been reshaping the features of international trade and has reset the parameters of trade policy, most importantly exchange rate management. The two countries are closely interdependent through different canals, from trade, where the U.S exports around 10 billion U.S. dollars (USD) of services while it imports more than 100 billion USD from China[1], to investment, as more than 3.3 trillion USD are involved in their two-way equity and bonds flows. This complex interdependence allows the two entities to affect each other's financial architecture through the use of different economic and monetary instruments[2]. On one hand, the 46th president of the United States, Joe Biden, has tried to put the U.S back at the forefront of

[1] "International Transactions | U.S. Bureau of Economic Analysis (BEA)." 2021. Bea.gov. 2021. https://www.bea.gov/data/intl-trade-investment/international-transactions.

[2] Keohane, Robert, and Joseph Nye. 1977. *Power and Interdependence*. New York: Pearson Education.

international trade through re-entering multilateral agreements without taking measures to stop the ongoing trade war. On the other, China is set to become the biggest economy in the world with the highest PPP-adjusted GDP, accounting for over 24 trillion USD[3]. It is vital to delve into the different factors that make China a trading giant and how their different policies have affected their main trading partner and competitor, the U.S.

This paper will specifically focus on the Chinese currency system and the extent to which it affects the U.S trade imbalances and monetary challenges. The aim here is to contribute to the study of China's trade success through the lens of its unique exchange rate system and management and to make a case for the undervaluation of their currency, the Yuan. More broadly, this paper will give the necessary information and tools to better understand what drives China and how to better apprehend what lies ahead.

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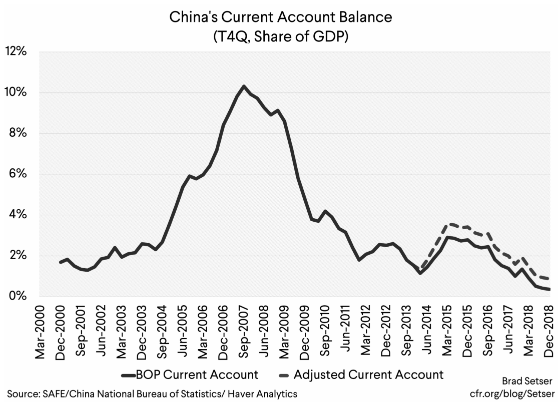
An Overview Of China's Exchange Rate System

From 1994 to 2005, the Chinese currency was pegged to the US$ at a rate of 8.28 per US$, allowing a fixed low valuation of the Yuan. In 2005, as the Chinese economy started to exponentially grow and saw its trade flows becoming more and more important, China's main trading partners put pressure on the government to allow the currency to appreciate, hence coercing the Chinese Central Bank (PBOC) to transition to a managed float exchange rate system.

Initially, the decision to peg the yuan to the US$ not only led to more trust in the Chinese economy but also led the current account balance to drastically increase[4] -as shown on Figure 1. below-. From a 10 billion dollar deficit in 1993 to a 36 billion dollar peaking high surplus in the early 2000s, China's decision to peg its currency to the US$ was the right move, reducing the value of the yuan by 50%.



[3] "GDP, PPP (Current International $) | Data." 2020. Worldbank.org. 2020. https://data.worldbank.org/indicator/NY.GDP.MKTP.PP.CD?end=2020&start=2000&view=map.

[4] Wafik, Doaa, and Assem Tharwat. 2020a. "China's Balance of Payments Evolution from Deficit to Sustainability Surplus." *International Journal of Industry and Sustainable Development* 1 (2): 50–64. https://doi.org/10.21608/ijisd.2020.101613.

Figure 1. China's Current Account Balance (T4Q, Share of GDP).

http://www.stats.gov.cn/tjsj/ndsj/2019/indexeh.htm

In 2005, the decision to depeg from the US$ allowed the currency to strengthen, leading to a revaluation. The pressure received by other trading partners made sense: not allowing the currency to fluctuate was harming other currencies as China's trading role grew immensely. The decision allowed the currency to fluctuate within a 0.3% boundary from the central parity and allowed a greater fluctuation frontier of 0.5% in 2007. Not letting the Yuan fluctuate artificially permitted the currency to remain undervalued as it was pegged to the dollar, regardless of what the international Yuan supply was. In this way, their exports remained relatively cheap and allowed China's export industries to keep growing. By 2005, China already had one of the most developed economies in the world[5] -surpassing Britain and France-, with well-established production chains, able to produce on large scales. The manufacturing sector accounted for over 40% of their GDP in 2005 and their net exports for 17.9%. Their investment capacity was also well set-up, with a 25.7% increase in national asset investment from the year 2004. The appreciation brought by the shift to a managed-float exchange rate (see Figure 2. on the Yuan exchange rate fluctuation to the USD) still strengthened their balance of payments, with imports from china being more expensive but the reliance on China's exports from other countries prevailed the costs of importing them.

[5] Banister, Judith, and Xiaobo Zhang. 2005. "China, Economic Development and Mortality Decline." *World Development* 33 (1): 21–41. https://doi.org/10.1016/j.worlddev.2004.09.003.

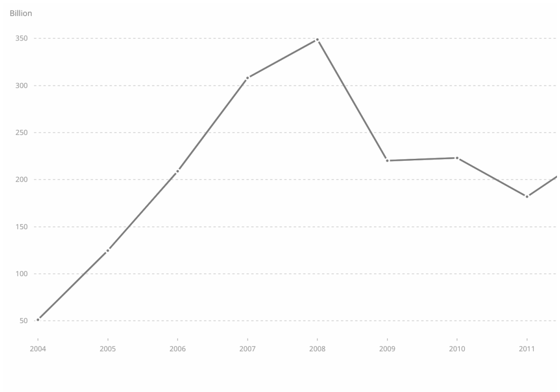


Figure 2. Net Trade in Goods and Services Balance of Payments, CurrentUSD

https://data.worldbank.org/indicator/BN.GSR.MRCH.CD?locations=US&view=chart

2005 hence came at the right time, both for trade partners to apply pressure, and for China to accept and shift to another system. Previously, imports remained cheap enough for other countries as the currency couldn't appreciate thanks to its peg to the USD. The Yuan transited to a semi-fixed exchange rate system, it was allowed to fluctuate within specific boundaries (+/- 0.3% against the USD and +/- 1.5 against a basket of other currencies including the euro) and naturally appreciated as China's exporting sector continued growing. The national income nonetheless kept expanding owing to the country's external dependence.

When the 2008 financial crisis hit the global economy, China obviously suffered losses from their assets in foreign capital markets and from outflow of capital that was previously invested in the country. But the major challenge faced by the Chinese economy was related to trade and to their steel exports because of a fall in production, a result of the global economic recession. On the other hand, their policy of having continuously purchased enough foreign reserves throughout the years allowed their currency -at this time semi-fixed- not to experience colossal fluctuations and to intervene in the foreign exchange market.

Although some argue that the main shield that permitted China to not undergo big shocks was the control over capital flows, the latter were still permeable, allowing different escape clauses[6]. Another unavoidable aspect is that until 2009, all transactions between China and the rest of the world were held in dollars, as the Yuan wasn't traded internationally. It enabled further stability in the currency. This monetary strategy has to be taken into account when approaching China's trade success, as discussed later. It can therefore be argued that the amount of foreign reserves actually helped protect the Chinese economy, especially the Yuan.

Trade Success: Methods and Currency Management

The will of stabilizing the currency had to come with broader economic development objectives. Trade development, which would allow for more efficient economic growth will later direct the country towards an exponential affluence of macroeconomic wealth. It is now essential to give an account of the domestic strategies that were employed.

What historians would consider as the first step of China's economic development were the reforms of December 1978 led by Deng Xiao Ping through his *Boluan Fanzheng* (eliminating chaos). The policies mainly consisted of infant protectionism of import-competing industries combined with the promotion of the country's export industries, which presently lead international trade. Actually, the first milestone came later with the 1986 five-year-plan. This introduced the concept of Production Networks for Sectors (PNEs), aiming at creating networks of different factories in a specific geographical area, Guangzhou being the most prominent. Through subsidies designed to attract these factories, the concentration would enable easier transportation access as well as more attractive prices for raw materials. This was part of the greater intent of targeting sectors. The result was the burgeoning of mechanical and electronic industrial goods.

On top of the foundation of PNEs, the establishment of special economic zones gained not only from the geographical areas that were destined to implement them, but also from special regimes: both administrative and corporate. On the administrative side, the access to private property allowed for greater flourishing of private institutions such as banks and modern companies. With regards to the corporate environment, an alluring tax system also attracted companies and investment in these

[6] Yongding, Yu. 2009. "China's Policy Responses to the Global Financial Crisis." Papers.ssrn.com. Rochester, NY. November 25, 2009. https://ssrn.com/abstract=1615956.

regions. For example, the lifting of import taxes that will later be transferred into exporting products. The combination of these specific statuses (administrative and corporate) led to huge increases in inflows of Foreign Direct Investments (FDIs), topping 28.3 billion USD between 1990 and 1999, greatly surpassing the 2.3 of the previous decade[7]. Another important factor that enabled the colossal economic ascension that China experienced in the late 1990s is the benefit brought by its controversy-ridden partners, Taiwan and Hong-Kong[8]. Both *territories* contributed greatly in terms of new management techniques and foreign capital investment. One popular example is the *Hong-Kong Connection,* the process in which Cathay entrepreneurs greatly contributed to China's special economic zone thrive thanks to massive investment and capital transfers. Lower wages on the mainland and specific trade relations (most of the imports in HK came from the People's Republic of China in the 1990s) were the factors enabling that tight commercial link[9].

After the peg to the USD in 1994, China kept ascending, accumulating more and more wealth. Its economic process was accelerated with its accession to the World Trade Organization (WTO) in 2001, empowering the country's trade liberalization until the country was hit by the 2008 financial crisis. Nowadays, the Chinese yuan's exchange rate is indirectly fixed to the USD through a reference, allowing the Chinese yuan to fluctuate within established boundaries that are modified depending on the fluctuation of a basket of chosen currencies.

Above we have shown the different strategies that China has carried out to reach the level before the 2008 crash, arguably the level they currently stand at with a 9% economic growth in 2009. Although the 1980s and 1990s were a period of great world trade expansion, China also made the call to peg its currency to the USD so that the Yuan would only fluctuate alongside the USD. This, associated with the non-internationalization of the Renminbi –mentioned previously– allowed for even greater currency and economic stability. 1994 came right at the end of the U.S savings and loans financial crisis and right before the Asian financial crisis of the late 1990s, undermining most south-east Asian economies and their currencies. It helped China avoid the worst of the turmoil with a stable currency and exchange rate relative to the USD (see Figure 3. below).

[7] Steng, Wanda, and Harm Zebregs. 2002. "Foreign Direct Investment in China: Some Lessons for Other Countries." February 2002. https://www.imf.org/external/pubs/ft/pdp/2002/pdp03.pdf.

[8] Clarke, Paul. 2008. "Does Growing Economic Interdependence Reduce the Potential for Conflict in the China-Taiwan-U.S. Triangle?" *American Journal of Chinese Studies* 15 (2): 57–68. http://www.jstor.org/stable/44288873.

[9] Hook, Brian, and Miguel Santos Neves. 2002. "The Role of Hong Kong and Macau in China's Relations with Europe." *The China Quarterly* 169 (March): 108–35. https://doi.org/10.1017/S0009443902000086.

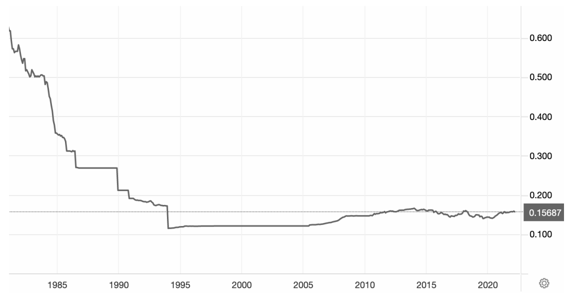


Figure 3. Chinese Yuan (CNY) to USD (USD); 1985-2020. https://tradingeconomics.com/cnyusd:cur

China and the U.S Interdependence: Features, Implications, and Challenges.

As written earlier, both the U.S and China are now closely linked in terms of economic relations. Trade is the most apparent facet of the close interrelation and interdependence between the two countries which comes with great challenges[10]. The U.S imports its goods from China while the latter heavily relies on U.S service exports, amounting to over 10 billion USD. Investment –closely related to international trade in general– is also a major aspect of commercial interactions between the two economic giants, as over 60 billion USD were involved in 2019 comprising both venture capital investments and FDIs[11]. While the two countries trade, their currency systems have a grip on each other. We will now delve into the underlying characteristics of the USD-Yuan relationship and how the policy habits of both central banks (the FED and the PBOC) affect the economic circumstances.

As aforementioned, the Yuan is not as internationalized as one would think. Indeed, before 2012, Chinese exports had to be paid in dollars. Since then, the Yuan was accepted as a transaction currency to Chinese exporters. This set in motion the slow process of internationalization of the Chinese currency.

In terms of effects on the U.S economy, the People's Bank of China (PBOC) intervenes in order to control the money supply of both the USD and the Yuan. It is the combination of trading relations between the two economies and the extensive use of USD for trade transactions that makes this external control possible. China's exports are paid in USD (as China exports mainly to the U.S), which involves the receiving of large amounts of dollars. These dollars, being useless to the Chinese exporters as their costs are denominated in Yuan, are exchanged to Yuan through the Chinese central bank, which then stores them in their foreign exchange reserves.

[10] Zhao, Quansheng, and Guoli Liu. 2010. "Managing the Challenges of Complex Interdependence: China and the United States in the Era of Globalization." *Asian Politics & Policy* 2 (1): 1–23. https://doi.org/10.1111/j.1943-0787.2009.01164.x.

[11] "Foreign Direct Investment, Net (BoP, Current US$) - China | Data." n.d. Data.worldbank.org. https://data.worldbank.org/indicator/BN.KLT.DINV.CD?end=2003&locations=CN&start=1994.

This allows the PBOC to have great leverage on the international supply of USD on the currency market, as they are able to control the amount of dollars issued internationally through different operations. This is known as stockpiling. This *power* position has been held by the Chinese government for a few decades, since the beginning of their exponential trade growth and increased U.S reliance on Chinese exports. China is now believed to hold over 3 trillion USD in their foreign exchange reserve, representing around 60% of their foreign currency reserve, more than any other country. China's central bank keeps these USD in order to limit the amount in circulation, hence keeping the value of the dollar high relative to the yuan's value. As China is export-dependent, exporting should lead the Yuan to appreciate, driving up the price of exports, leading to their trade surplus to decrease and slowing their economic growth. China then needs to keep the Yuan low enough to remain competitive. The Yuan is in this manner artificially lower than the dollar, as the PBOC makes sure that there is always more Yuan than dollars. By intervening in this way, it gives a competitive advantage to China, and thus affects the U.S trade dynamics, as having a stronger currency harms American export competitiveness.

Additionally, what also gives China an overwhelming influence position is their ownership of U.S domestic debt. China is known to own over 15% of the U.S national debt[12], accounting for over 1 trillion USD. Although it is greatly symbolic of the countries interdependence, it also enables China to continue conducting their export-led growth policies as the financing of the U.S debt, to a large degree, allows the U.S to keep buying Chinese goods. Even though the two countries are involved in a trade war, China's leverage remains dormant. Their leverage could lead to a decision to offload their USD dollar reserve that could provoke a currency crisis, it being worth too little and leading to sky-high inflation rates, coercing the FED to higher their nominal interest rates. However, the decision to sell their U.S dollars is unlikely, as it would cause the Yuan to appreciate, making China less competitive for its export-oriented economy.

Both countries find themselves in a very competitive situation with complex interdependence. The monetary decisions of one affect the other and the trade policy and growth model of the other counts on the currency system of one to support their strategy. Apart from the different attributes listed above, one could argue that the China wave[13] relies not only on early-adopted blueprints, but also on a unique model of tight control and a government-attached central bank, a compelling feature for

[12] Labonte, Marc, and Jared C. Nagel. 2021. "Foreign Holdings of Federal Debt." *Congressional Research Service* RS22331 (July).

[13] Zhang Weiwei. 2012. *The China Wave Rise of a Civilizational State*. Hackensack, N.J.: World Century Pub. Corporation.

the sino political system –as opposed to western monetary theories promoting the independence of central banks.

Having considered the Chinese export-oriented growth success and its dominant position in Sino-American economic relations, both in terms of trade and of currency, it is reasonable to look at the threats that may arise for China's trade scheme and how it could affect its partners.

We have observed that the Yuan's undervaluation gives the country a predominant position; however it may underlie structural challenges. The first, perhaps the most obvious, is its progressive dependence on the exterior. Immediately before the financial crisis, exports amounted to more than 50% of its GDP[14] with economic crises of all sorts (financial, supply chain, fiscal, etc.) threatening wealth dynamics. The other is the heavy reliance on foreign investment, with the country experiencing towering investment rates that could, in the long-term, result in asset bubbles caused by an abundance of liquidity.

As China holds over 120 million USD of assets and 35 billion USD of FDIs in the U.S and as the U.S current accounts deficit keeps increasing, the question arises of how China should react. The worsening of the U.S' current account deficit harms China, as they suffer from constant capital losses. One way of helping China recover from their capital losses would be to help the U.S recover from their current account imbalance through the issuing of USD out of their foreign exchange reserve. That would lead to the dollar depreciating, thus assisting the U.S in regaining a competitive advantage, but would also lead to greater losses as the depreciation of the dollar harms Chinese asset values in American domestic capital markets. However, on the other hand, if the PBOC decides not to issue dollars to reduce their capital losses and the U.S' current account deficit, USD will keep piling up regardless of the Chinese foreign exchange reserves, which would lead to larger losses in the future. This will only be exacerbated if the decision is made to purchase more USD. To employ Yongding's expression (2010)[15], this is the dollar trap in which China finds

itself. One solution brought by the Chinese economist would be for China to reduce its *twin surplus* (meaning its capital and currency account positive balance). In other words, shifting its reliance on external demand by boosting domestic demand where the production would be transferred into national consumption and national revenues -all in Yuan-, without needing to go through the USD. Here, the issue resides in reducing China's dependence on exports to the U.S, meaning reduced purchases of U.S debt securities by the Chinese Central Bank, directly endangering the U.S financing system, as China is the major external debt contributor. Another less likely alternative would be measures to internationalize the Yuan. There, the expected result would be the reduction of

[14] "China Statistical Yearbook 2020." 2020. Stats.gov.cn. 2020. http://www.stats.gov.cn/tjsj/ndsj/2020/indexeh.htm.

[15] Yongding, The Impact, 24-25.

the so-called *twin surplus*, and would consist of increasing the yuan money supply through diverse operations such as quantitative easing or the adoption of the Yuan as foreign exchange reserves in other countries. The adoption of the Yuan in international currency reserves started spreading slowly, such as in Saudi Arabia where it is now accepted for oil purchases, but the role of the currency in international transactions is still insufficient.

In short, this knotted linkage plunges China into an unprecedented enticement that will require strong decisions by the central government and that will, willingly or not, lead to substantial damages to the U.S economy.

Conclusion

Exchange rate systems and trade features have been proven to be the most salient features of Sino-American interdependence throughout the 21st century. Since China's *four modernization* strategies led in the 1970s, the *land of the middle* hasn't stopped expanding economically through its increasing role in international trade, providing them with an unquestionable financial status. The leverage they have gained over the U.S over the years is due to their unique currency management, from their exchange rate system to their foreign reserve policies. We have, in this paper, examined how China succeeded in becoming the most eminent world trade partner due to its distinguished export-oriented strategies.

The latter heavily relied on unique domestic policies combined with unequaled currency management. This specific currency regime allowed them to accumulate USD and become the U.S biggest external debt creditor. It is noteworthy to interrogate how much deeper this interdependence can go: an extended implication and influence on the U.S economy could lead to unprecedented damages. The internationalization of the Yuan[16] and the shift from an export-dependent economy to a domestic demand-led economy seem to be potential solutions for China but they lie in the hands of the current decision-makers. The prevailing situation hence could be approached as a macroeconomic bubble between the two world biggest economies. Besides, their non-economic disparities might as well play a role in how fast this bubble will explode.

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