

Chapter 19 – China’s Exchange Rate Regime: An Update

This year, China’s foreign reserves surpassed \$2 trillion. This massive stockpile, which accounts for about 30% of all the currency reserves in the world today, has risen by a factor of more than 13 since the start of the decade, when it stood at \$156 billion (see Figure 1). And, for China, there’s no end in sight. What prompted this unprecedented accumulation of reserves in one country? What are the Chinese doing with the reserves? What are its implications going forward?¹

The increase of reserves reflects China’s astonishing, sustained current account surpluses – the excess of their exports of goods and services over their imports (see Chapter 10 and Figure 2). Between 2005 and 2008, these surpluses averaged over \$400 billion annually – more than 9% of China’s GDP – and were rising. With the European economy weakened by the financial crisis, China may be poised to replace Germany as the world’s largest exporter.

China’s fixed exchange rate regime supports these enormous export surpluses. Because of their concern over social stability, China’s leaders have resisted a rapid appreciation of their currency – the *yuan* – that could harm the export sector and add to unemployment. And, as a consequence of its productivity growth and expanding labor force, China needs to grow rapidly to prevent a rise of unemployment.

Since July 2005, policymakers in China have allowed the value of the yuan to appreciate by more than 20% versus the U.S. dollar, and somewhat less against most other currencies.² But overall, the appreciation has been too modest to offset China’s rapid gains in *international competitiveness* – the ability to make traded products at prices that attract global demand.

When a country runs a current account surplus, it is running a capital account deficit. This means that it is either making loans to foreigners, or buying their assets. What assets does China purchase with its surpluses? It turns out that China has solidified its role as the leading financier of the U.S. government. According to the U.S. Treasury, China owns about \$1.2 trillion of Treasury debt. This is equivalent to nearly 30% of all foreign holdings or 9% of the entire stock of outstanding federal debt. Beyond these bond holdings, Chinese firms also have increased direct investment abroad.

It is a paradox that China – with outstanding investment opportunities at home – continues to lend in such large volume to the United States, a mature economy with

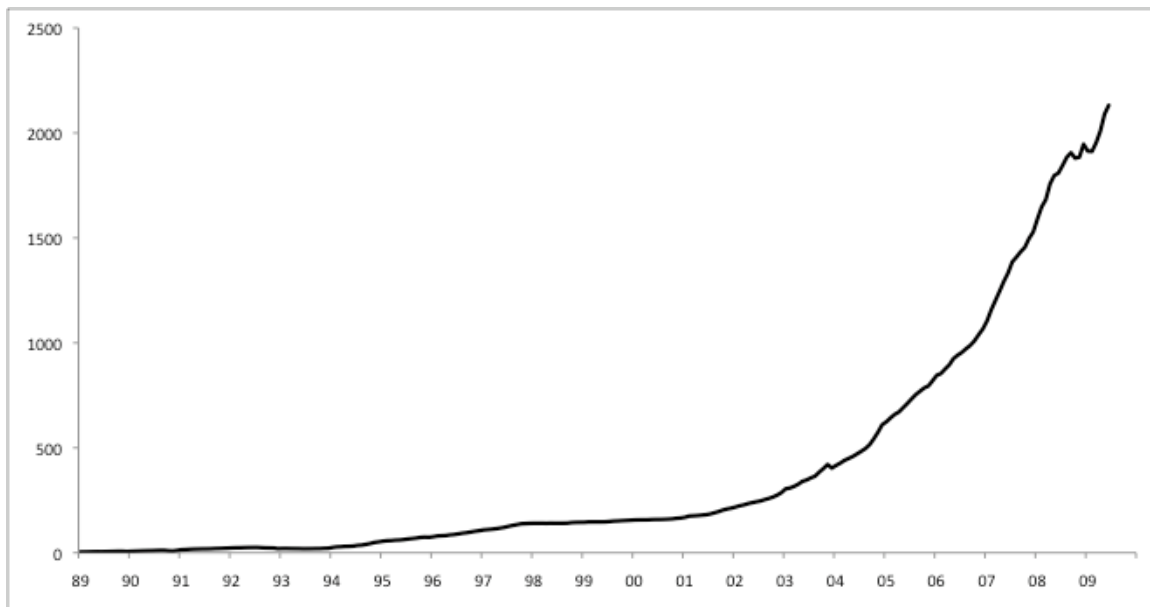
¹ This module draws extensively on Eswar Prasad and Aaron Sorkin, “Sky’s the Limit? National and Global Implications of China’s Reserve Accumulation,” Brookings Institution, July 22, 2009; http://www.brookings.edu/articles/2009/0721_chinas_reserve_prasad.aspx

² In real terms, the yuan’s gain is slightly larger because the price level has climbed farther over this period in China than in the United States.

lower expected returns on investment. The odds are high that China eventually will face large currency losses on its foreign assets when the yuan rises to reflect the country's trade competitiveness. China's reserve managers seem well aware of this prospect, and would probably like to reduce their exposure to the U.S. dollar. However, the fixed exchange rate regime offers them little room for maneuver. If China tried to lower its dollar holdings significantly, the yuan would rise against the dollar, not just causing losses in China's foreign reserve portfolio, but potentially harming its exporters as well.

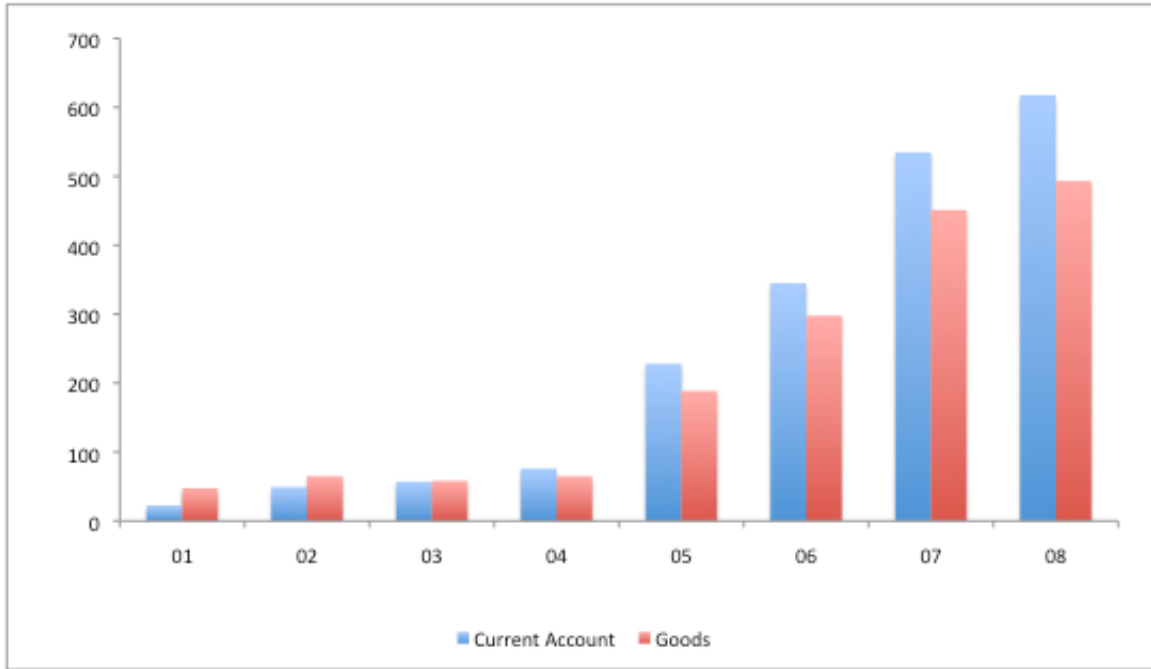
China's leaders can slow the rate of reserve accumulation by promoting domestic consumption, but this process is likely to be a gradual one that takes many years. China's households save an extremely high portion of their income as a precaution against rainy-day threats (such as unemployment or illness) and to provide for retirement. The savings that cannot be utilized well at home flow into the country's enormous external surpluses. Until these excess savings dwindle, China's foreign reserves probably will continue to rise rapidly.

Figure 1. China – Foreign Reserves (Billions of U.S. Dollars), 1989 – June 2009



Source: The People's Bank of China.

Figure 2. China – Current Account: Total and Goods (Billions of U.S. Dollars), 2001-08



Source: China State Administration of Foreign Exchange (SAFE).