Chinese Currency Yuan - Major Game Changer

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We can argue how freely the U.S. Dollar is allowed to float given recent Fed money printing programs like QE2.

China has continued piling up massive exchange reserves holdings with $3 trillion in largely U.S. Dollar denominated assets and counting. How much is enough before China is willing to budge on the yuan's value?

China's Currency: the Yuan or Renmimbi

Definition: The Chinese yuan, also known as the renmimbi, is China's national currency. The yuan has an important role in keeping China's economy competitive. Why? China keeps the yuan pegged to a basket of currencies, most notably the U.S. dollar. As of January 31, 2013, the yuan was worth a little more than fifteen cents.

However, most forex traders look at the yuan/dollar exchange rate the opposite way. In other words, a dollar is worth 6.3080 yuan. By the way, this is its highest level in 17 years. China is allowing the yuan to gradually rise to slow export growth and offset inflation.

Despite the yuan's controlled rise, many analysts think the Chinese government keeps the yuan artificially low. China does this to keep its products cheaper than U.S. products, thus increasing its exports to the U.S.

Some analysts say the yuan needs to rise 30% in value. They argue that if China allowed the yuan to float freely, it would be more valuable than the dollar because of China's strong economy. However, others argue that the yuan has already appreciated 25% against the dollar since July 2005.

The yuan has risen 6% annually, which converts to 10% due to China's higher inflation. This is a healthy rate of increase – any more would have negative economic impacts for China. The country is desperately trying to keep its 1.3 billion people employed to raise their standard of living. China's leaders are afraid they will revolt if growth isn't fast enough. Even though China is the world's third largest economy, ($10 trillion, right behind the European Union and the U.S.), its GDP per capita is only $7,600. This is worse than much smaller countries such as Jamaica or Ecuador.

How Does China Keep the Yuan at a Fixed Exchange Rate?

In a world of volatile foreign currency movements, exactly how does China maintain a fixed exchange rate? First, China promises to redeem dollars for yuan at the fixed rate. To do so, it must keep a good supply of dollars in reserve. Instead of holding dollar bills, it holds U.S. Treasuries, which it can quickly sell for dollars. As China's economy grows, it must buy more and more U.S. Treasuries to meet the growing number of yuan. As a result, China is the largest holder of Treasuries.

In November 2011, China held more than $1 trillion in U.S. debt. This makes the U.S. a little more vulnerable to China's political pressures. For example, in 2009 China called for a new global currency to replace the dollar. China was concerned because the dollar's value was declining, a result of the U.S. flooding the world with dollars to boost is own economic growth. China rattles its sabers like this whenever it sees its holdings of dollars lose value.

China's Yuan Policy Keeps the Dollar Strong

Right now, the dollar is used as the currency of choice for most international contracts. All oil contracts must be transacted in dollars. This has been the case since the U.S. went off the gold standard in 1973.

The dollar being the world's global currency is one reason the U.S. debt has grown so large. It keeps the dollar in demand, thus keeping Treasury interest rates low. In a way, China's desire to keep the Yuan low makes it buy U.S. Treasuries. This keep yields low, which helps the U.S. housing market by keeping mortgage rates low. For more on how this works, see The Relationship between Treasury Notes and Mortgage Interest Rates.

Will China's Yuan Policy Change?

China could, theoretically, threaten to sell its Treasury holdings, putting the value of the U.S. dollar into freefall. However, it's not in China's best interests to do so. By threatening to sell U.S. Treasuries, China would quickly devalue its own holdings. Even so, it's been unwise for the U.S. to allow itself to become so indebted to any other country.

China has allowed some limited forex trading in Shanghai. To let the yuan freely float, China should allow all its residents to hold foreign currency and buy foreign assets. This would allow the Chinese Government to hold less dollars and lessen the trade imbalance with the U.S. Then there would be less focus by the U.S. Congress calling for an increase in the yuan's value.

When Currencies Collapse

Confidence in the dollar and the euro continues to falter, threatening the international monetary system. The world has faced such monetary collapse before: in the 1930s, with disastrous results, and less catastrophically in the 1970s. Understanding these two precedents is crucial to successfully navigating the crisis today.

According to a growing chorus of pundits and economists, China – already the world's most prolific exporter, largest sovereign creditor, and second-largest economy – will someday soon provide the world's reserve currency. According to this view, just as the dollar dethroned the British pound in the interwar years, so the yuan will soon displace the dollar, striking a blow to U.S. interests. "Could become the premier reserve currency by the end of this decade, or early next decade?"

This view has gained traction as Chinese leaders have launched a concerted effort to internationalize the yuan. During the G-20 summit in November 2008, at the height of the financial crisis, Chinese president Hu Jintao called for "a new international financial order that is fair, just, inclusive, and orderly." Beijing soon began to encourage the use of its currency in international trade, swap arrangements between central banks, and bank deposits and bond issuances in Hong Kong. During the first six months of 2011, trade transactions settled in yuan totaled around $146 billion, a 13-fold increase over the same period during the previous year. By mid-2011, yuan deposits in Hong Kong equaled $85 billion, a roughly tenfold jump. The yuan is already accepted as a form of payment in Mongolia, Pakistan, Thailand, and Vietnam. Chinese authorities have indicated that as soon as 2015, they want the yuan to be included in the basket of major currencies that determines the value of Special Drawing Rights (SDRs), the reserve asset issued by the International Monetary Fund. And Beijing has announced its intention to transform Shanghai into an international financial center by 2020.

On Sept, 29, the House of Representatives passed a bill with overwhelming support from both Democrats and Republicans. It would punish China for keeping its currency undervalued by slapping tariffs on Chinese goods. Everyone seems to agree that it's about time. But it isn't. The bill is at best pointless posturing and at worst dangerous. It won't solve the problem it seeks to fix. More worrying, it is part of growing anti-Chinese sentiment in the U.S. that misses the real challenge of China's next phase of development.

There's no doubt that China keeps the renminbi, its currency, undervalued so it can help its manufacturers sell their toys, sweaters and electronics cheaply in foreign markets, especially the U.S. and Europe. But this is only one of a series of factors that have made China the key manufacturing base of the world. A simple appreciation of the renminbi will not magically change all this.

Chinese companies make many goods for less than 25% of what they would cost of manufacture in the U.S. making those goods 20% more expensive (because it's reasonable to suppose that without government intervention, China's currency would increase in value against the dollar by about 20%) won't make American factories competitive. The most likely outcome is that it would help other low-wage economies like Vietnam, India and Bangladesh, which make many of the same goods as China. So Walmart would still stock goods at the lowest possible price, only more of them would come from Vietnam and Bangladesh. Moreover, these other countries, and many more in Asia, keep their currencies undervalued as well.

From July 2005 to July 2008, under pressure from the U.S. government, Beijing allowed its currency to rise against the dollar by 21%. Despite that hefty increase, China's exports to the U.S. continued to grow mightily. Of course, once the recession hit, China's exports slowed, but not as much as those of countries that had not let their currencies rise. So even with relatively pricier goods, China did better than other exporting nations.

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