Chinese Yuan and the American Dollar

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The economic relationship between China and the United States has been a hit and miss discussion over the years. One question, in particular, has stimulated more than speculation, but empirical research of whether we know that China's currency is undervalued is certainly a trigger to perform further research. The two currencies that I choose for my discussion AND assignment is the Chinese yuan and the United States dollar. Although, curious to determine if the yuan is undervalued, undervaluation of Yuan (Y) against the dollar ($) and its impact on the competitiveness of US exports has compelled me to perform research on the two currencies. This assignment will focus on past history, current, and future history of the exchange rate.

Background Data

The USA claims that the undervaluation of Yuan (Y) against the dollar ($) adversely impacts the competitiveness of US exports, and debate on what measures to take to correct this undervaluation problem has created considerable tension between China and the USA (Hilland & Devadoss, 2013). I must note that China has a long history of fixing its exchange rate relative to the dollar, the yuan being fixed at about 8.28 per dollar until July 2005 (Highfill & Wojcikewych, 2012). Before I began, according to the currency converter, the current exchange rates as of today (November 4, 2015) is 1 CNY = equals 0.157734 USD (XE Currency Converter, 2015). For example, approximately the value of 1000 (Y) is equal to 16.00 ($). In this case, the cost of living in China is cheaper than in the US (mainly in small towns).
Past and Current Reflections

The Chinese Yuan

Reflecting on the yuan, before 1994, China had a dual system for its currency (renminbi-yuan) which consisted of an official exchange rate and market-based exchange rate (Hilland & Devadoss, 2013). There were two different types of exchange rates and currencies, as only the Chinese citizens had access to the Yuan while foreigners were only to purchase foreign exchange certificates to be only used at certain locations. Finally, in 1994, China unified the two exchange rates and pegged its currency at 8.7Y/$; foreigners were allowed to purchase Chinese currency (Hilland & Devadoss, 2013). Even at this time the US considered the Yuan undervalued at that fixed rate.

Furthermore, China has had its period of decline since 1994. For some reason, the yuan has been kept undervalued which has prevented the yuan from rising against the dollar ultimately changing competitive position against China. Therefore, despite the requests from the United States and Japan, their efforts have been relentless. In fact, the Chinese government has refused to give into the pressure to end its currency peg and appreciate Renminbi (RMB) in the near future (Maniam, Mei, & Dheeriva, 2006). China’s persistence is of not revaluing reflecting on past information is solely due to the fear of weakening its competitiveness in the international market, decreasing its annual economic growth, and increased unemployment rate (Maniam et al, 2006). Additionally, speculations occurred that exchange rate may cause damage to an already ill financial system.

The American Dollar

Exchange rates play pivotal roles in international trade, economic growth and other related areas. In the economic literature, the exchange rate is considered as a variable that has a
direct impact on an economy's external competitive position (Bonitsis, 2013). A common measure of this is an economy's international competitiveness ratio. It is calculated as the product of the quotient of the foreign to domestic price levels and the exchange rate (Bonitsis, 2013). In regards to the dollar, some have shared that the exchange rate has experienced periods of under and over valuation. Policy makers have responded to perceived U.S. dollar exchange rate misalignments by taking coordinated actions in the foreign exchange markets. A closer look at exchange rates fluctuation on the United States economy shows that several reasons caused the impact. For example, Bonitsis (2013) posits that the use of forward, futures, and options contract for foreign exchange exposure impacts the exchange rate fluctuations. Secondly, domestic and foreign producer’s acceptance of lower profit margins in order to maintain markets share to address an exchange rate effect. Lastly, the dollar is the numeraire invoice currency for traded goods. This holds nominal prices stable as the exchange rate fluctuations. Overall, the three factors creates an exchange rate filter that the prices of traded goods go through irrelevant in terms of their impact on the United States economy.

**Current Reflection**

Interestingly, currently, China’s central bank decided to devalue its currency which caused its biggest one-day loss in two decades (WSJ, 2015). The thought is that it will help drive the currency toward more market driven movements, in addition to the fear of its slow growth. Although, the yuan has proved to be stable for about a decade, the recent devalue was the most significant downward turn to the yuan since 1994. China actually sets a midpoint for the value of yuan against the United States dollar, but not all the time does it follow procedures when it comes to daily moves or adjustments (Wei, 2015).
Since June 2014, the dollar has strengthened dramatically. According to Prakken, Joel, and Varvares (2015) if the dollar is strengthening as a result of sharply marked down growth prospects abroad, then the decline in risk-free rates in the United States might be accompanied by widening credit spreads and a rising equity risk premium. This is then followed by a lower path of foreign GDP, which is tied to the adverse effects of the rise of the dollar. It is good news about driving the dollar higher risk spreads here could narrow, and the equity risk premium might decline (Prakken, Joel, and Varvares, 2015). This would be the case where we would say "the dollar is rising on strength;" and that increase cannot reduce growth, only trim the expected increase.

**Future Reflection**

Before discussing the future of these currencies, it is necessary to point out that the International financial theory predicts that the real exchange rate of a currency is “stationary.” That means that it fluctuates around its mean, with no tendency to drift off and a systematic tendency to move back to the mean if for some reason it is moved away from it (Tatom, 2007). This occurs because of “purchasing power parity” (PPP), which holds that the same bundle of goods and services will tend to sell for the same price (in a given currency) (Tatom, 2007). Consequently, the exchange rates must regulate to reflect price variances in the domestic price levels in the two countries, or, given a fixed nominal exchange rate, price levels adjust to make PPP hold.

As for the Yuan, there has been research that it could possibly become an international currency in the future. Today, many products that are in the United States and other places are mainly from China. Due to the raw materials and products, China has been a force to reckon with in the global arena. Exports alone has been a huge demand and has continued to increase which
makes the Yuan high in demand for international trade (Ping-Fu & Lau, 2012). It is now viewed that China will begin to reform the Yuan exchange rate step by step, maintain the currency rate as an advantage for economic development. However, RMB is expected to have an increase in her value. It is concluded that RMB cannot be internationalized for the time being until the value of it is properly valued (Ping-Fu & Lau, 2012).

Regarding the United States dollar, as mentioned in my discussion post I spent a good amount of time searching for the best forecast. The dollar dynamics is often referred to being treated as a mystery. However, it is no secret that international investments are motivated by the value of the dollar, which some would say is the core currency around the world. Through my research, I did find that forecasting difficulty is aggravated by the difficulties associated with the dollar being a reserve currency central to the global monetary system. Conflicts over the global monetary system, or lack thereof, have led to what seems like never ending predictions of the dollar's demise, which has obviously not happened. The dollar may be on a long-term downtrend, but along the way, there have been years of range-bound behavior and significant spikes in the opposite direction (Rzepczynski, 2014). I would also like to report that the author of the article- "The dollar trap: How the U.S. dollar tightened its grip on global finance" posits that "There are no close substitutes or rivals, and the dollar's "exorbitant privilege" will likely persist regardless of regular reports of its demise. By the importance of capital flows, currency management, and foreign central banks' demand for safe assets, the dollar will continue to be the dominant force in international finance even with the decline of US economic power (Rzepczynski, 2014)". As for the yuan, the US has continued to push for revaluation.
Conclusion

The economic relationship between China and the United States has been an important topic over the years. One question, in particular, has stimulated more than speculation, but empirical research of whether we really know that China’s currency is undervalued or not. The two currencies the Chinese yuan and the United States dollar has both experienced its ups and downs; however, both have managed to hold its ground through it all.
Reference


