Chinese Approach to Exchange Rates and Impact on Trade

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The United States and China have embarked on considerable deliberation in the United States trade and the value of the Chinese currency among academics and politicians alike. Over the years, research on the two topics has consistently addressed the subject by investigating the equilibrium real exchange rate between the yuan (CNY) and the dollar (USD), with results exposing the undervaluation in the yuan since the 1990’s. In the wave of unprecedented globalization, exchange rates, and capital flows are inevitably becoming two of the most significant economic variables connecting the world (Kim & Kim, 2015). Defined as the relative price of two currencies such as the CNY and USD, exchange rates are relative prices that can be express in two ways (Bekaert & Hodrick, 2012). Nevertheless, this paper will address the Chinese approach to exchange rates and the effect this has on trade with the United States.

Chinese Approach to Exchange Rates

Overview of the Yuan (Renminbi)

An evaluation of the Yuan shows that before 1994, China had a dual system for its currency (renminbi- "yuan) which entailed 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. What seem to happen was China was able to export
more to and import less from the USA, creating a bilateral trade deficit that has been a major concern for the USA.

As previously researched and described in week 2 and 4 discussions, the United States presented to Congress several bills signifying the necessity to revalue the Yuan. The bills were intended to take corrective measures such as the imposition of tariffs on Chinese goods to force China to adjust the value of the Yuan in line with market value (Hilland & Devadoss, 2013). In response to persistent US objections, China, in 2005, ended its fixed exchange rate system and changed its pegging based on a basket of currencies. Additionally, research specifies that the target foreign exchange rate is set by imposing restrictions and controls on any capital transactions. That has led to China's large-scale purchase of US dollars and dollar assets.

During the global financial crisis of 2007-2008, the appreciations of the RMB (yuan) stopped (Kabirou & Gao, 2014). Additionally, in the period of 2009-2012, the foreign exchange rate of the RMB to the dollar remained at 6.83 as a measure to protect China from the low global demand for its products. Since June 2010 up to the present, the RMB appreciated from 6.83 to 6.18, which equals only 10.5%. Since June 2012, the RMB has only appreciated by 2.1% (Kabirou & Gao, 2014).

Interestingly, I came across a study that was performed by Haque (2014) to test whether the Yuan was actually undervalued or was the United States unreasonable in their claims. Results revealed that the Yuan is intentionally kept undervalued by the Chinese Central Bank in order to have a comparative advantage for their products in the global market. He goes on to mention that there are two exchange rate determinations, the PPP, and IRP. The Purchasing Power Parity (PPP) states that the exchange rate between two currencies adjusts based upon the movement of the consumer price index (CPI) for the two different countries. The second theory of exchange
rate determination is the Interest Rate Parity (IRP) theory. According to IRP, in the country that has higher interest, the value of their currency will depreciate in the forward market so that no one can make a gain by taking advantage of interest rate differential (Haque, 2014).

**Chinese Approach**

According to Bekaert and Hodrick (2012), exchange rate systems can be divided into three groups: currencies with floating exchange rates, currencies that have fixed or pegged exchange rates, and currencies in which the exchange rate is kept in a target zone or allowed to follow a crawling peg. Chinese economists were debating on alternatives of a few sets of options on the exchange rate system before the reform in 2005. Nevertheless, China system leaned toward pegged currencies which were meant to control and keep the Yuan at pegged values.

**Trade Impact on China and the United States**

A closer look reveals since 2007, China’s exports have increased making them the second largest exporter. As a result, international trade became significant for the Chinese economy but led to the rise of the economy’s exposure to international shocks such as exchange rates movements (Zhang & Liu, 2012). Previously mentioned, the Chinese government is under force from the United States trade officials pressuring for the Yuan to appreciate. However, an appreciation of the Yuan could possibly increase the prices of exporting products in terms of foreign currencies, which may lead to a decrease in the demand from export markets (Zhang & Liu, 2012). The response of appreciation force could cause China to squeeze their profit margin to keep a competitive exporting price while preserving market shares. How does this affect the United States? Well, if their revenue cannot cover their costs, companies would choose to exit exporting markets, which can result in the United States relying on the local market rather than
China’s products. This can be good for the United States domestic companies since many products are made in China and shipped to the United States.

**Conclusion**

It is evident that the United States and China have embarked on substantial deliberations on many topics over the years. Two topics discussed in this paper is the United States trade and the value of the Chinese currency. Until today, research on the two topics has consistently addressed the subject by investigating the equilibrium real exchange rate between the yuan (CNY) and the dollar (USD), with results exposing the undervaluation in the yuan. In this paper alone, globalization, exchange rates, and capital flows are inevitably becoming two of the most significant economic variables connecting the world (Kim & Kim, 2015). The Chinese approach to exchange rates and the effect this has on trade with the United States is essential to both countries.
Reference


