

Macroeconomic analysis essay



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Over the last few years, the economy of China has grown at a considerably high rate averaged at nearly 10% annually. Due to this enormous growth, China now influences the economy of virtually every country all over the world. This is more apparent and frightening, considering the United States' economic relationship with China. The economic growth of China has affected prices of imports and exports, wages, interest rates and most significantly, the value of the dollar. Until 2005, China pegged its currency to the U. S. dollar, but as from July 2005, it linked its currency to other currencies rather than dollars and let its currency appreciate by 2. 1% (Hill, 112). The central bank of China did this by buying and selling the dollar dominated assets in exchange of printed yuan in order to eliminate excess supply or demand for the yuan. Due to this, the exchange rate between the dollar and the yuan, basically, remained constant irrespective of changes in economic factors which could have otherwise destabilized the yuan relative to the dollar.

Since these reforms, China has continued manipulating its currency to its advantages, such as giving exporters an unfair trade advantage. This paper will provide an analysis of China's yuan against the U. S. dollar for the past 5 years ending in 2010. Also, the exchange-traded fund (ETF) of yuan is discussed in depth.

Recently, the U. S. policymakers had been having debates over China's currency policy. The policy adopted by China has been linked to the rapidly growing United States' trade deficit with China and the decline of employment in the U. S. and the emergence of China as a major economic power. The U. S had been claiming that the yuan is undervalued with respect

to the dollar. Good indicators that the yuan is considerably undervalued are the sharp increase in China's foreign exchange reserves and its large trade surplus. China's foreign exchange reserve grew from \$403 billion in 2003 to \$1.5 trillion in 2007, while its trade surplus totaled \$178 billion in 2006 and hit \$268 billion in 2007 (Sexton, 216). This clearly illustrates how the yuan is undervalued in reference to the dollar. Having in mind that the yuan is not fully convertible in international markets and the tight restrictions maintained by China, the country is able to maintain the exchange rate policy and still pursue its domestic goals, such as full employment using monetary policies.

Analysts believe that undervaluing the yuan against the dollar will have both costs and benefits to the United States' economy. Undervaluing the yuan means that imports from China would be relatively cheap in comparison to when the currency is market determined. This would lead to inflation and lower prices for the U. S. consumers. The lower prices of exports from China will impact negatively on the U. S. industrial sector. This would lead to industries reducing their production capacity and consequently employment. On the other hand, due to undervalued yuan, there would be a reduction in the U. S. exports to China, because the exports would be much more expensive. This would lead to the loss of job opportunities by the U. S. workers.

In addition to letting the yuan appreciate at a slower rate, China is also trying to make the yuan much more convertible. Most of Chinese trade is now being settled using the Chinese yuan. China has continuously encouraged its companies to invest outside China. Also, foreign companies in

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China are, to a certain extent, being permitted to issue yuan denominated bonds rather than importing dollars to fund new investments.

Since China linked the yuan to other currencies rather than the dollar, its currency has risen by approximately 4.5% per year. The performance of yuan had been consistently solid unlike other currencies. In comparison to the United States, prices of many services in China are relatively low. China's GDP per capita is approximately 12 times less than that of the U. S. and therefore, the relative prices level in the U. S. are already significantly less than that in China. Analysts believe that this, in the long run, would cause economic distortion.

Intense pressure has been put on China by finance officials from all over the world to allow the yuan to appreciate quickly. For instance, Mr. Schumer, a chief critic of China's currency policy, argues that the weak currency is causing inflation in China and consequently contributing to the global trade imbalances. This is because the trade imbalances make Chinese products cheaper overseas. One of the major reasons for the U. S. asking for a stronger yuan is because a stronger yuan would help boost the United States' exports by making them relatively cheaper, thus more appealing in China and elsewhere all over the world.

In 2005, the U. S. senate brought out a bill that would lead to sanctions being enforced against countries whose currency is distorted to its advantage. In particular, the yuan was the main focus of the legislators. China is now rated the United State's second largest supplier of imports (Arrora, Vivek & Athanasios, 42). United States' imports from China are mainly labor intensive

consumer goods, such as games and toys, shoes, textiles and apparel and electronics. Some U. S. industries are now facing some challenging competition posed by the imported goods from China. Undervalued currency of china has contributed to the reduction in the production capacity of such industries. China's intervention in currency markets in order to limit its currency against other currencies particularly, the dollar, has made it emerge the world largest holder of foreign exchange reserves, summing up to \$3. 2 trillion in 2010. Most of these reserves are invested in the U. S. public and private securities.

China controls a massive exchange rate reserve in the United States, amounting to \$1. 4 trillion in 2007. United States policy makers postulate that this might present a problem since most of these reserves are held in the U. S. dollars denominated assets called the U. S. Treasury Securities. At the moment, 40% of the U. S. national debt is controlled by foreigners, since the U. S. has gradually ceded the control of its long-term interest rates to foreign Central Banks, mainly China (Gros, Mayer, Ubide & Perotti, 74).

Many Central Banks are diversifying their forex reserves from dollar assets to other currencies' denominated assets. This is not the case for China which has recently created the China Investment Co. Ltd. The cooperative is the largest government owned in the world and was capitalized with almost \$300 billion (Chen, Jian & Yao, 82). Its function is to invest its vast forex reserves in higher yielding assets. Diversification of Chinese reserves would have a negative implication on the U. S. economy.

In conclusion, before a decision is reached concerning the yuan, there is a lot to be considered. For instance, if the yuan is allowed to float, China's currency would definitely appreciate against the dollar. The net effect of yuan appreciation would either benefit or harm some U. S. economic sectors. The United States' trade deficit with China has not, necessarily, prevented the U. S. from reaching full employment. However, China's exchange rate reforms needs to be taken cautiously. For instance, there have been claims that the policy is preventing changes in the global trade imbalances. This will eventually undermine the world economic growth. Both Chinese and U. S. officials have agreed that China should undertake some economic reforms in order to obtain more economic growth and boost domestic consumption.