

Chinese foreign currency reserves swell by record amount

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Chinese Foreign Currency Reserves Swell By Record Amount Chinese Foreign Currency Reserves Swell By Record Amount Main purpose of this article:

This article tries to raise public alarm over the swelling foreign exchange reserve levels of China and how this contributes to the country's "worsening inflation problem" (Bradsher, 2011).

Why does a high level of foreign currency reserves lead to inflation?

This has to do with its effect on the renminbi's exchange rate vis a vis the US dollar. A high level of reserves causes the renminbi to appreciate against the dollar. The problem is this will make China's substantial exports more expensive; thus, losing its competitive advantage. This then could lead to the loss of jobs by millions of people working in the export industry. This led to China's central bank's decision to keep the value of its currency low. To do this, it prints renminbi at a "furious pace in order to buy the dollars and euros" that come in through trade surpluses and foreign investment (Bradsher, 2011). However, this spawns another problem. The additional renminbi issued causes the money supply in the country to rise even further. What was not discussed in the article is the direct impact of the level of money supply on inflation. A high level of money supply circulating in the economy causes aggregate demand to rise. This increased demand for goods and services is what pushes general prices to go up.

Looking at China's foreign reserve levels, in the third quarter of 2010, it increased by \$194 billion. In the fourth quarter, it jumped by \$199 billion to raise the total to \$2.85 trillion. This increase was much larger than what economists had expected. During this time, China "doubled its intervention in the currency markets to about \$2 billion a day" (Bradsher, 2011). And so,

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the country's money supply was 19.7 percent higher in December than a year earlier.

The increase in money supply though is not solely due to the central bank's efforts to keep the value of the renminbi in check. Banking loans have also risen and measures taken by the central bank to slow down lending, primarily by increasing bank reserve requirements have proven to be ineffective.

References

Bradsher, K. (11 January 2011). Chinese foreign currency reserves swell by record amount. The New York Times. Retrieved 14 June 2011. http://www.nytimes.com/2011/01/12/business/global/12yuan.html?_r=1