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Are China's High Currency Reserves a Threat to the United States and the World?

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Are China's High Currency Reserves a Threat to the United States and the World?

Antony Peter Mueller[1]

1 Introduction.

China's persistent export surpluses with the United States have made it the largest holder of foreign exchange reserves and the main international investor in U.S. government securities. In 2018, China's trade surplus with the United States has reached a new high. Yet China's export-led growth strategy has reached its limit. Whatever the specific outcome of the current trade talks, China's trade surplus will diminish, and the stock of its international reserves will fall. The next step in China's development strategy would require a fundamental policy change to more markets and less state control. It remains doubtful, however, whether the country's current leadership has the insight to make such a change.

2 Growth strategy

Over the past decades, China has followed the export-led growth model. This development strategy is based on three pillars: first, earning income from abroad through exports, second, getting high-profit rates by keeping the wage rate down, and, third, making the companies reinvest their profits in business enlargement.

An export-led development policy requires an undervalued exchange rate. In its effort to gain international competitiveness, the Chinese government devalued its currency in various steps throughout the 1980s and the 1990s and only since 2007 has allowed some revaluation. After China gained membership in the World Trade Organization (WTO) in December 2001, a sharp rise of its stock of foreign exchange reserves happened that peaked around four trillion US-dollars in 2014.

China's accumulation of foreign exchange reserves took off after its access to the World Trade Organization. Deceived by the reports of its own intelligence community and the analyses of the World Bank, the West took it for granted that China was on its way to a liberal democratic order and a capitalist economic system when in fact China held on to its mercantilist strategy. Different from the promise at the time of the entry into the WTO to phase out its state-owned companies, stop its currency manipulation, and respect foreign property rights, the Chinese government continued promoting its state-owned companies as the country's national champions in strategic industries. As the well-informed China specialist Michael Pillsbury claims, "… America is losing to China, and the reason is simple: China cheats. It steals technology, promotes Chinese monopolies, and unfairly insulates its state-owned companies from foreign competition."

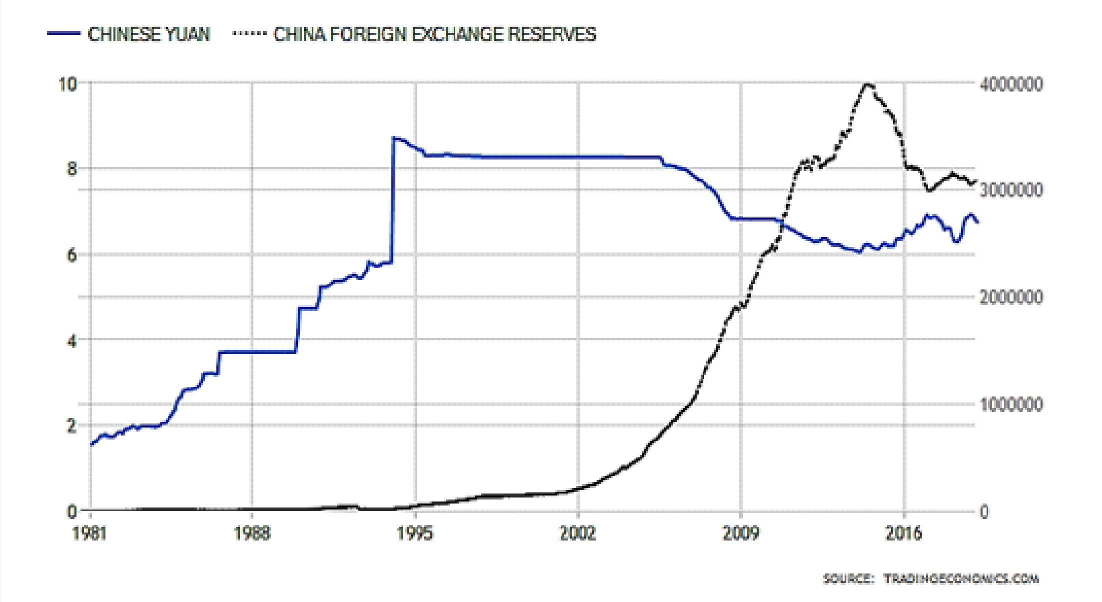
[1] Professor Associado 4 do Departamento de Economia da Universidade Federal de Sergipe.

3. Reserve holdings

China's accumulation of foreign exchange reserves reached a top of close to four trillion in June 2014. Since then, reserves have come down and at the end of 2018, the currency reserves stood at 3.09 trillion US-dollars (fig. 1)

Foreign exchange reserves are currencies held by the country's central bank that are not this country's own money. For the United States, currencies other than the US-dollar count as assets in the balance sheet of the Federal Reserve System, while for China, the US-dollar and currencies other than the national Chinese currency are foreign exchange reserves. A country's stock of international reserves rises when the national central bank buys more foreign currency than it sells. For China, this means that the Chinese foreign exchange reserves result from a policy when the Chinese central bank had been buying more foreign currencies than it sold throughout the years from 1980 to 2014 and since then has been a net seller.

Figure 1: Chinese foreign currency reserves and the exchange rate of the dollar-yuan exchange rate



A country's international reserves exist in the form of liquid foreign assets, which, in the case of China, mean that most of the Chinese foreign currency reserves are held in securities of the U.S. government. Thus, the Chinese accumulation of U.S.-dollar reserves has been an important part of financing the federal government's budget deficit of the United States.

The U.S. Treasury informs that as of December 2018, China is the top holder of American government securities with 1.23 trillion, followed by Japan with 1.04 trillion U.S.-dollars. Including the dollar assets beyond government securities, China's currency reserve holdings in U.S.-dollar comprise about two-thirds of its overall reserves followed by euros and Japanese yen. Mainland China's share as a creditor of the US federal debt stands at about five percent.

Beyond the United States, China accumulates its large export surplus also with Hongkong, which, however, re-exports most of its imports to the United States. Yet it would be wrong to assume that China has an export surplus across the board. In fact, it has considerable trade deficits with the highly industrialized upstream exporters like Germany, South Korea, and Japan and with the luxury goods exporters, and has deficits also with exporters of natural resources and of agricultural products like Saudi Arabia, Australia, and Brazil. If America should diminish its role as the largest absorber of Chinese exports, it will become difficult for China to maintain the present level of its currency reserves.

In terms of the current account balance, China's surplus is already shrinking. After a peak of 10.1% in 2007, China's account surplus in percent of its gross domestic product fell to 1.3% in 2017. For the first half of 2018, China registered its first current account deficit in twenty years.

Conclusion

China's authoritarian government kept the wage rates down and along with the undervalued exchange rate could reign in domestic consumption. This laid the groundwork for the export surplus of its manufacturing sector and the country's industrialization. Reinvesting the profits which the companies earned from their exports provided the funds to expand the capital base of the Chinese economy. This strategy is ending.

In as much as internal consumption will increase at home, China's domestic savings surplus shrinks and thus its current account surplus is about to vanish. As a consequence, China's stock of international reserves will fall. Because the necessity to maintain an undervalued currency is receding, and the access to the U.S.-market loses in importance, the central bank will see less need to buy U.S.-dollars and hold on to them as international reserves.

China's currency reserves present no threat the United States. There is rather the question who will fill the gap when China no longer contributes to financing America's federal debt.