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The Yuan vs. the Dollar: China and the United States are already in a "Hot" War

by

William R. Daly
LCDR, USN

A paper submitted to the Provost, Naval War College, for consideration in the Prize Essay Competition for the Jerome E. Levy Economic Geography and World Order Prize.

The contents of this paper reflect my own personal views and are not necessarily endorsed by the Naval War College or the Department of the Navy.

Signature: ______________________
W. R. DALY, LCDR, USN

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**14. ABSTRACT**

The United States and China are now in a Hot War. This Hot War is named as such because it is a money-centric conflict where speculative money (i.e., "Hot" money in FOREX) reigns as an instrument of economic and financial power. Ironically, just as the Cold War symbolically ended with the fall of the Berlin Wall, this Hot War began with another fall: the managed fall of the U.S. Dollar (USD) that began in 2002. As China's economic health improves, its currency is increasing pressured to float from its pegged state. The relationship of the CYN to the USD not only challenges U.S. economic and financial power, but also stresses U.S. national security interests.

To fully understand this Hot War, the United States must study the history of the CYN and the pegging and floating processes of the CYN. Understanding this background will enable the United States to comprehend how the Chinese authorities will use this currency instrument in the battles of this Hot War. The battles of this Hot War will be fought over or manifested in several issues: the current account imbalance, economic growth (Chinese and American), regional and external outreach efforts, and the obvious future relationship between these two currencies.

To excel in this Hot War the United States must pursue three objectives: maintain a more attractive economy than China, maintain more attractive financial markets than China, and maintain the world's leading reserve currency. To not maintain these positions is to give up shares in the markets of world power and influence and thus to accept unnecessary risk in obtaining U.S. national security goals.

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The United States and China are now in a Hot War. Ironically, just as the Cold War symbolically ended with the fall of the Berlin Wall, this Hot War began with another fall: the managed fall of the U.S. Dollar (USD) that began in 2002. Now, as China and the United States face-off over the implications of this devalued USD and the related benefits accrued by the pegged Chinese currency, the Hot War battles are emerging. The primary battlefield, which is both the fulcrum of economic and financial power and the arena from which the other battles spawn, is the foreign exchange (FOREX) market. Here, the USD valiantly attempts to defend its reserved position in the world, while it is dragged into collisions with the Chinese Yuan (CYN), which is pegged to the USD, as it has been since 1994.[1]

This Hot War does not imply that there will be real military conflict between the two nations; rather, the value of these two currencies, which perennially draw speculative (i.e., "hot") money in the FOREX markets, is the primary characteristic of this money-centric conflict. As China's economic health continues to strengthen, the United States is putting significant pressure on the Chinese to float their currency and allow market forces to determine currency values, which, in turn, has significant financial and economic impacts for both nations. This existing relationship between the CYN and the USD and the impacts of changing this relationship represent a capital Hot War through which Chinese economic and financial power will not only challenge U.S. economic and financial power, but will also stress U.S. national security goals.

## The Chinese Build-up

[1]The Yuan is pegged in a small variation band around 8.27648 CYN to the USD. The generally recognized pegged rate is 8.28 Yuan per 1 U.S. Dollar (USD).

American economic and financial power is well known. U.S. banking systems, sophisticated capital markets, the reserve status of the USD, and America's longstanding role as an economic engine of the world are as close to established facts as one can come when speaking of money-driven phenomena.[2] But to understand the battles of the Hot War, the United States must also examine the history of the CYN, why it is pegged to the USD, why it will eventually float, and how and when it will likely be floated. Understanding this background will enable the United States to comprehend how the Chinese authorities will use this currency instrument in these Hot War battles.

## The History of the CYN

The current Chinese currency system is the Renminbi ("The People's Currency") and its dollar-equivalent unit is the Yuan.[3] It was first issued in 1949, shortly before the Communist takeover. When the Chinese communists structured their command economy, they also set severe currency exchange restrictions, which endured in a similar manner until 1978, when, under the leadership of Deng Xiaoping, the PRC began to open up its economy. The first attempt at currency exchange liberalization was a dual track currency system where the CYN could be used only for domestic markets and foreign currency exchange certificates could be used external to China. As a result of limited desirability and black market development, in the 1980s and 1990s the Chinese set up swap centers for FOREX certificate turn-in and abolished the dual-track currency system.

[2] The United States produces approximately 25 percent of world Gross Domestic Product (GDP). David R. Fancis, "U.S. Financial Power: A Bang and a Whimper," Christian Science Monitor, January 15, 2004. Accessed online at <http://www.globalpolicy.org/empire/economy/2004/0115whimper.htm> [08 May 2005].

[3] In international foreign exchange the Renminbi is designated RMB and the Chinese Yuan is designated the CYN. This paper will refer to the Chinese Yuan (CYN) because it is widely recognized and is more suited to the discussions of this analysis.

By 1996 this FOREX focus brought the convertibility of the CYN to where it is today: it has current account convertibility but not capital account convertibility.

## Why Peg to the USD?

In 1994 the Chinese pegged the CYN to the USD, the world's reserve currency since World War II.[4] Ultimately their rationale for pegging the currency was simply that it would guarantee greater stability. This stability was vividly demonstrated during the Asian Financial Crisis, which hit the economies of East and Southeast Asian nations in mid-1997. Several Asian nations saw a massive devaluation of their currency as speculators dumped their holdings (e.g., Indonesia, Thailand), however this pegged protection "rendered the RMB (Renminbi) far less vulnerable to domestic or externally driven speculative attacks."[5]

This externally insured stability was, and remains, necessary for three primary reasons. First, the Chinese wanted to encourage development in their country. The reserve USD they held added greater legitimacy and value to their own currency, thereby instilling confidence in foreign investors looking at the Chinese market. Coincident with growth generated by foreign investment, the Chinese bought themselves time to improve the second and third reasons they needed financial stability: their banking system remains weak and unreliable and their financial markets are immature and ineffectual.

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[4] Pegging the CYN to the USD requires the Chinese to buy U.S. dollars (reserves), which provides the meaning for "reserve currency" status. The Chinese must buy these dollars in order to give their currency its pegged value, rather than just selecting an arbitrary value. The 1994 peg was 8.70 CYN to the USD and has been at 8.28 CYN to the USD since September 1998.

[5] Shalendra D. Sharma, "Stability amidst Turmoil: China and the Asian Financial Crisis," Harvard Asia Quarterly 4 (Winter 2000): Accessed online at <http://www.fas.harvard.edu/~asiactr/haq/200001/0001a006.htm> [18 May 2005].

The Chinese banking sector is considered China's financial Achilles Heel and, therefore, banking reform "could be a make or break issue in China's rise to economic prominence."[6] China's domestic banking system is comprised of three segments: the "Big Four" State Owned Commercial Banks (SOCB), twelve joint stock banks, and city commercial banks.[7] All of these sectors have some common, fatal characteristics. Foremost among these flaws is that a high number of their assets are non-performing loans (NPL)--estimates are often as high as fifty percent of assets on the books of the SOCB are NPL.[8] Because loans are often state-directed and not profit-oriented (i.e., political loans), they are not paid, the banks declare fictional assets, and, thus, the system exists with an insufficient capital base. This lack of consistent lack of profit is a second major flaw. A third major, frequent flaw is the immature supervisory structure. The China Banking Regulatory Commission (CBRC) is attempting to enforce discipline but is simply fighting an uphill battle as a result of the size of the problem, the political nature of the banking system, and corrupt banking and corporate governance.

The financial markets of China are also underdeveloped and currently unable to support the economic largess of the country. This is most evident in two fundamental areas: FOREX and capital markets. China's delinquency with FOREX, following so many years of a pegged currency is simple to comprehend--they have not the people, the

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[6] Javed Hamid, "Corporate Governance and Banking Reform in China," Shanghai, China, 23 April 2005, 1 [remarks online]; available from <http://www.ifc.org/ifcext/eastasia.nsf/AttachmentsByTitle/Hamid_Governance_Speech/$FILE/Hamid_Governance_Speech.pdf> and Lkd. Read related speech by Director Javed Hamid on Corporate Governance and Banking Sector Reform at "Step by Step: Corporate Governance Models in China;" Internet, accessed on 02 May 2005.
[7] The "Big Four" are four large state-owned banks. They are the Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China and China Construction Bank. These four banks control approximately 70 percent of the banking assets in China.
[8] Raviprasad Narayanan, "Credit Crisis," Asian Affairs October 2004, 2. <http://www.asianaffairs.com/oct2004/china.htm> [03 May 2005].

facilities, nor the training to manage their currency in the volatile, speculative world of FOREX. Realizing this, the Chinese foreign exchange regulator, the State Administration of Foreign Exchange (SAFE), created a joint international-domestic trading group to start trading currency pairs (e.g., dollar-sterling, euro-yen) in 2005, thereby allowing "domestic banks to master the art of trading volatile currencies" and to facilitate "trading a more flexible yuan."[9]

The Shanghai Securities Exchange (SSE) and the Shenzhen stock market, more so than the Hong Kong Securities Exchange (HKEx), represent the poor development of the Chinese capital markets.[10] The China Securities Regulatory Commission (CSRC) is attempting to correct the two most often cited deficiencies of these markets. First, the CSRC is working to "end the division between local-currency priced 'A' shares, which initially only domestic residents could buy, and hard-currency-denominated 'B' shares, which were originally reserved for foreigners."[11] Second, the CSRC is attempting to expand the membership of the exchanges beyond the current membership, which consists of nearly all state-owned enterprises (SOE). The CSRC is making limited progress and the markets have not been profitable investments since prior to 2001. China's bond market remains an unsophisticated, small, and undeveloped market.

In addition to the stability that pegging offers, pegging the currency generally enables export-oriented economic growth. This unyielding orientation in the Chinese current account, when combined with foreign investment, has largely contributed to China's continued, heated economic boom. Although the Chinese likely did not

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[9] "Softly, softly," The Economist 275, (April 2, 2005): 68.
[10] The Hong Kong Exchange (HKEx) was previously developed and managed under the British colony and is a more sound institution (with some different rules) than the SSE.
[11] Economist Intelligence Unit, China Risk: Financial Risk (07 April 2005): 5. Accessed online at <http://riskwire.eiu.com/index.asp?layout=display_print&doc_id=1098186909> [03 May 2005].

anticipate a 2002 USD devaluation when they pegged the CYN in 1994, they are certainly reaping the benefits of that relationship now. Ironically, as China's economic engine gets larger, China is forced into greater consumption and may soon see a trade deficit as it imports that which it needs to fuel its engine. With that backdrop, China is now under pressure to float it currency.

## Why float the Yuan?

In addition to American claims of currency manipulation to create a favorable trade imbalance towards Chinese exports, China is under pressure to float the CYN from the European Union (EU), the World Trade Organization (WTO), and the International Monetary Fund (IMF). WTO pressure is primarily targeted towards Chinese banking reform and is legitimate in that banking reform by 2007 is an obligation for China in accordance with its WTO accession agreement. The IMF frequently speaks about the Chinese currency and consistently argues that the Chinese should move "towards greater flexibility" in addition to "a readiness to tackle structural problems in the banking system."[12] But the greatest pressure on China comes from the other primary engine of the world economy, the United States.

China is feeling the pressure from a large force of U.S. political, manufacturing, lobbying, and business entities. As early as 2003, President Bush was pressuring both China and Japan to stop intervening in the currency markets.[13] More recently, much of

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[12] Anne O. Krueger, "China and the Global Economic Recovery," International Monetary Fund Keynote address at the American Enterprise Institute Seminar, Washington, DC (January 10, 2005), 6. <http://www.imf.org/external/np/speeches/2005/011005.htm> [04 April 2005]. Nearly every week, as can be found on the IMF's speeches webpage, the IMF leadership makes public statements encouraging the Chinese to adopt a more flexible exchange rate mechanism.

[13] Like China, Japan buys large USD-denominated reserves (primarily U.S. treasury bills).

the political rhetoric is coming from the Congress, the Secretary of the Treasury, and the Secretary of Commerce. In a released statement following the April 2005 meeting of the G-7 Finance Ministers and Central Bank Governors, U.S. Treasury Secretary John Snow impatiently stated, "China is ready now to adopt a more flexible exchange rate."[14] Additionally, the China Currency Coalition, a coalition of U.S. Senators, U.S. Representatives, and U.S. industrial, service, agricultural, and labor organizations is actively pushing for China's currency revaluation and is fully supporting the pending 27.5 percent tariff on Chinese imports that was recently proposed in the U.S. Senate.[15]

Despite relentless U.S. pressure, the Chinese appear to be rigidly holding on to a sound economic principle of maturing their weak sectors (banking, financial) before pursuing the flexibility (and vulnerability) of a fully convertible currency. As is typical of most Chinese statements on the matter, the Chinese state news agency Xinhua reported that the current exchange rate needs to be adjusted "at an appropriate time and in an appropriate way."[16] The Chinese have stated that currency liberalization is a broad policy goal, but they have not provided a timeline of when to meet that goal. It is likely that, even in the face of international pressure, the Chinese will not fully float their currency until they are comfortable with the risk of the FOREX market and their banking and financial systems are matured.

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[14] U.S. Department of the Treasury, "Secretary John W. Snow Prepared Statement following the Meeting of the G-7," (Washington, DC: 16 April 2005), 2. <https://www.ustreas.gov/press/releases/js2384.htm> [15 May 2005].

[15] The China Currency Coalition maintains a website where all of their membership, issues, speeches, and releases may be found. They are advocating a variety of countermeasures against the Chinese, whom they believe are operating at a currency undervaluation of 40 percent or more. Their website is: <http://www.chinacurrencycoalition.org>.

[16] "U.S. Treasury Secretary Snow calls for currency flexibility as G7 meets," Financial Facts Business News, 15 April 2005. <http://www.finfacts.com/irelandbusinessnews/publish/article_10001391.shtml> [01 May 2005].

### How and When will the Yuan float?

As stated, the Chinese will revalue their currency not as a result of a timeline, but as a result of comfort with foreign exchange and improved efficacy of their capital and banking structures. Although speculators (moving their "hot" money) anticipate a valuation as early as late 2005, the banking system looms large as the obstacle to this accomplishment. Because the WTO obligations for banking reform do not take effect until 2007 and the infusion of more money is necessary to write-off the high numbers of NPL's, this 2005 speculation seems merely a guess influenced by the belief that China will respond to the pressures of the United States, the EU, and the IMF.

More relevant at this point is how the Chinese will float the currency. The Chinese would be unwise to simply implement a free-floating mechanism and thereby expose themselves to a hard transition with significant upward pressure on the CYN. Instead they will likely manipulate the appreciation of the CYN and implement a "crawling" peg. This incremental revaluation will provide greater stability as it relieves the upward pressure on the currency. The Chinese may choose to further relieve this pressure by establishing a basket peg, where they will peg the CYN to various currencies (i.e., a basket), such as the yen, the euro, and the USD. This management of the currency flotation will continue to excite external pressure and, in fact, may bolster the case of currency manipulation against the Chinese; it will, however, likely continue to demonstrate reasonable, disciplined improvement of the exchange rate mechanism.

## The Hot War Emerges

This power fulcrum of currency exchange thus enables the emergence of the battles (issues) of this Hot War. More importantly though, these issues and attaining their resolution sound the alarm when examining U.S. national security goals. The United States is correct in encouraging CYN liberalization as soon as possible because China's burgeoning financial power will provide a turbo-charge to its economic engine and this should only be the result of "policies that further strengthen market incentives and market institutions."[17] Chinese ascendance to economic superpower shall not be at the expense of the manifest and noble U.S. goals of "political and economic freedom, peaceful relations with other states, and respect for human dignity."[18] Should the United States prove malleable on the achievement of these goals with China, Chinese power will not be properly calibrated. American quantification, judgment, and action towards Chinese economic power are necessary because "when power relationships are correctly calibrated, wars tend to be avoided."[19]

The battles of this Hot War will be fought over or manifested in several issues. The first, as previously mentioned, is that of the current account imbalance. The second is the closely related issue of economic growth (American and Chinese) and the numerous subsets of this issue. The third battle involves the regional and external methods to countering the efforts of the other economic heavyweight. Finally, and perhaps most obvious, will be the future of the currency relationship between the CYN and the USD.

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[17] The White House, The National Security Strategy of the United States of America (Washington, DC: Government Printing Office, September 2002), 17.
[18] The White House, 1.
[19] Robert D. Kaplan, "How We Would Fight China," Atlantic Monthly (June 2005): 50. The type of war to which Kaplan is referring is the traditional conflict between nations, which involves military force.

## Current Account Conflict

Although the American current account deficit dates to well before the late 1990s, this is a good starting point for examining the issue as it relates to China. In the late 1990s U.S. businesses and President Clinton pushed hard for and secured normalized trade relations with China and Chinese membership in the WTO.[20] However, in 2002, the United States commenced devaluing the dollar and then soon began applying significant amounts of pressure on China to float its currency. The pegged CYN was naturally devaluing with the USD and therefore making items manufactured in China less expensive for other nations to import. This, in turn, contributed to the creation of today's trade imbalance in which the United States and other nations are importing far more goods (e.g., inexpensive Chinese-made goods) than they are exporting. This current account deficit for the United States reached 5.5 percent of GDP in 2004.[21] Add projected Chinese economic growth figures on top of this deficit and the outlook remains bleak.[22] As a result of this continuing flood of Chinese exports, the United States, the Committee for the Implementation of Textile Agreements (CITA), of the U.S. Department of Commerce, announced on May 13, 2005 that it will "invoke safeguards on textile imports from China."[23] Additionally, in its annual Report to Congress on

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[20] China joined the WTO on December 11, 2001.

[21] Rodrigo de Rato, "Correcting Global Imbalances--Avoiding the Blame Game," International Monetary Fund, Keynote address at the Foreign Policy Association Financial Services Dinner, New York, NY (23 February 2005): 2. <http://www.imf.org/external/np/speeches/2005/022305a.htm> [01 May 2005]. In 2004 the U.S. current account deficit was $666 Billion.

[22] On March 21, 2005 China's State Council predicted GDP growth through 2010 to remain around 8 percent. Although the accuracy of Chinese reporting is periodically called into question and the Chinese are attempting to restrain excessive and rapid growth, international economic commentary generally agrees with this anticipated level of growth. This released data may be found at People's Daily Online (English) at <http://english.people.com.cn/200503/2/eng/20050321_177555.html> [04 April 2005].

[23] U.S. Department of Commerce, "CITA announces that it will invoke safeguards on textile imports from China," (Washington, DC): 13 May 2005. Available at <http://www.commerce.gov/opa/press/Secretary_Gutierrez/2005_Releases/May/13_CITA.htm> [15 May 2005].

International Economic and Exchange Rate Policies, the U.S. Department of the Treasury stated China is causing "a substantial distortion to world markets, blocking the price mechanism and impeding adjustment of international imbalances."[24] Shots are being fired in this Hot War.

## Economic Growth

The second issue of economic growth is complex, yet it offers insight into the intricate and circuitous variables that comprise this Hot War. By pegging their currency to the dollar, the Chinese force themselves to buy USD assets (primarily U.S. treasury bills) in order to give their currency the pegged value. If they did not do this, they could not supply the foreign exchange market with the stated value of their currency, thereby invalidating the stated value. China closed 2004 with $609.9 Billion (U.S.) in foreign reserves and 70 percent of that was in USD.[25]

When the Chinese float their currency and obviate the need to purchase so many USD-denominated assets, they will effectively stop funding U.S. spending. This will result in higher U.S. interest rates and slowed American economic growth. This is ironic in that, as the United States calls for immediate flotation of the CYN, the second-order impacts (beyond cooling down Chinese exports) are rarely presented. These impacts, when overlaid with additional variables such as poor U.S. savings, lower U.S. taxes, and high mandatory U.S. spending (e.g. Social Security and Medicare), can

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[24] U.S. Department of the Treasury, Report to Congress on International Economic and Exchange Rate Policies (Washington, DC: May 2005), 14.

[25] "China's Foreign Exchange Reserves, 1977-2005," China State Administration of Foreign Exchange (SAFE), Beijing, 2005. This official information is posted at www.safe.gov.cn. This website is currently operating intermittently, but the same data is taken from the official SAFE website and posted at <http://www.chinability.com/Reserves.htm> [15 May 2005].

highlight undesirable economic fallout for the United States of a CYN valuation. On the other hand, a slowing of the U.S. economy and less spending by Americans will result in fewer purchases of Chinese exports, thereby causing China to hurt itself with the currency valuation that it is seeking. For both nations, mitigation of these impacts may lie in reaching towards other markets and other nations.

## Reaching Elsewhere

Much like the Cold War, this Hot War involves peripheral arenas of competition between the economic behemoths, which will be pursued to allow power leverage and flexibility that may be restrained in direct confrontation. Latin America, Africa, and India are developing as key foreign battlegrounds. A distinct Chinese focus on Latin America began with a 2001 visit by President Jiang Zemin to Chile, Argentina, Uruguay, Cuba, Venezuela, and Brazil. The Chinese have followed this with successive high-profile visits and greater penetration of markets and industries in Latin America.[26] Like Latin America, the Chinese began pursuing dramatically closer relationships with African nations in 2001. As is the case with Latin America, much of this is based on access to resources and competition for world market access (and therefore, influence) with the United States.[27] China's relationship with India, a neighbor with whom it has traditionally had an uneasy and sometimes violent relationship, has not improved as rapidly as those of other parts of the world. However, the April 11, 2005 pact signed between China and India, which called for "enhanced diplomatic relations and economic

[26] Between November 2004 and February 2005 President Hu spent sixteen days in the region and Vice President Zeng Qinhgong visited six nations.

[27] Beijing's improved relations with African nations have manifested in many fashions. Debt forgiveness, state and private firm investments into Africa, tariff reductions have all been tools that the Chinese have used to solidify these markets and relationships.

ties"[28] and which followed some other bilateral agreements, was a bit of an international relations surprise. However, when these relationships are viewed as the molding casts for new economic and financial protective armor against the United States, there is nothing surprising about them.

## Long-term Currency Relationship

As the Chinese and the Americans continue to foment these global interdependent relations the rivalry between the CYN and the USD will continue. It is highly possible, although not in the near future, that the CYN will attain the level of reserve currency.[29] The Chinese also will start to see their cost of living rise in conjunction with their economic growth and therefore may lose the ability to flood world markets with cheap labor and cheap goods. This, in turn, will turn potential investors elsewhere and reduce growth rates. The Chinese must balance their success so that they maintain strong positive growth but do not become victims of their accomplishments. This is their strategic challenge, and their success in meeting this challenge will influence the long-term currency relationship between the CYN and the USD.

The American approach to this future relationship will also involve a balancing act. The United States must promote the growth and strength of the Chinese economy and Chinese financial markets while also ensuring the USD maintains its premier position in currency markets. The strategic challenge for the United States is to ensure external

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[28] "China and India sign border accord," CNN.com, April 11, 2005. <http://www.cnn.com/2005/WORLD/asiapcf/04/11/china.india/index.html> [18 May 2005].

[29] Most economic commentary is willing to classify the Japanese Yen and the Euro as reserve currencies as a result of the stabile, reliable conditions surrounding investment in these currencies. These two may also become battlefields for the United States, but this analysis only considers the CYN.

investors view the USD as the currency of choice while the CYN strengthens at a rate that will not ultimately displace the USD.

**Perhaps this Hot War is simply…speculation?**

One could challenge this argument of a Hot War by claiming the Chinese are a long way from either overtaking the U.S. economy or improving on the U.S. financial markets and, thus, treating them as a threat is too speculative. The major fault with this argument is that it unwisely ignores trend analysis. Most economic estimates demonstrate that with continued disciplined management of financial progress and increased management of economic growth, the Chinese GDP will surpass that of the United States before the middle of the century.

One could also voice disagreement with the idea of an aggressive China and instead see U.S. behavior as overreaction and threatening. In addition to also ignoring trends, this often used and always misguided argument loses steam when confronted with the variety of forms of Chinese aggression.[30] Additionally, history has shown the fallacies of communist ideologies and institutions, and the United States is right to only seek "a constructive relationship with a changing China."[31] The world no longer has room for communist regimes in any form, most certainly one whose rise to power came from its non-communist attributes.

Finally, one could challenge the idea of a Hot War and state that there will either be no war, or merely a currency war, between these two powers. This argument simply

[30] Recent Chinese aggression has manifested itself in overt statements against U.S. military power, land claims against India, excessive claims regarding the Spratley Islands, human rights violations, and statements and posturing against Taiwan.
[31] The White House, 27.

ignores too many realities of the situation. First, the complex interaction of currencies today put them at the crux of international economic and financial behavior. Second, as post-Iraq anti-Americanism has demonstrated, the world is interested in deemphasizing military power. Thus, power will be found in other areas and economic and financial fora are areas where power exertions will increase. Finally, globalization does result in increased world connectivity and leadership of these connections will most likely go to the nation which has the economic and financial foundation to enable leadership (e.g., through investment in superior technology, through aid or investment in other states or industries, or through offering a better deal than the competition).

## Recommendations

The recommendations for the United States are centered on two principles: mitigate the extent of the Hot War but maintain a position of strength, or, if that is not possible, win the Hot War. Both principles ultimately involve engagement of the opponent from a stronger economic and financial position. Thus, both require the United States to pursue three objectives: maintain a more attractive economy than China, maintain more attractive financial markets than China, and maintain the world's leading reserve currency.

Maintaining a more attractive economy than China requires immediate attention. Foremost, the United States must reduce the federal deficit and encourage U.S. savings. Reduction of the federal budget deficit will likely have the most positive impact of all actions. The hard decisions and prioritization that are required to reduce the budget need not attempt deficit elimination; rather they must attempt to reduce the deficit to a more manageable level. Second, America must reduce its current account deficit by importing less. A healthy dose of the Asian export-focus would do wonders for America's economy and future. Third, sustained GDP growth must remain a major focus area. Coincident with GDP growth will be economic wealth, which will afford "international economic wealth" and "international purchasing power."[32] Realizing that this may compete with balancing capital and current account deficits, this is the tertiary of these three issues.

American financial markets are unrivaled--because they possess superiority for global investment, they are strategic assets for America that must not be allowed to diminish. Every day alternative markets become more sophisticated, more stabile, and more attractive. So too must the American markets. Through technology, derivative investments, and new investment opportunities the United States must continue to attract the world's most desired investors. This continual process requires both government and private attention because market entities often develop new ideas, which eventually require federal regulation to attain full and fair implementation. This issue of financial markets relates not only to the first recommendation of sustained economic growth, but also to the final recommendation of currency excellence.

The USD cannot relinquish its reserve currency position. Although the euro and the yen (and perhaps the Yuan one day) will likely become more prominent reserve currencies, the USD must remain preeminent. Fortunately this status is aided significantly by accomplishment of the prior objectives. America's economic growth, monetary transparency, capital market prowess, combined with investor confidence in the

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[32] Klaus Knorr, ed., Economic Issues and National Security (Lawrence, KS: Allen Press, Inc, 1977), 101.

dollar put the United States in the sweet spot of economic and financial power. This spot must be retained.

## Conclusion

The world is becoming more interdependent and globalized and yet a Hot War between economic superpowers is occurring. This globalization "transforms economies, produces unprecedented levels of wealth as a kind of "invisible hand in the marketplace writ large, transcending individual states and washing over the entire globe."[33] The challenge becomes how to best influence the "invisible hand" without replacing market forces. The answer to that challenge, for the United States, is found in placing itself in economic and financial positions of strength, which are often positions that will deter an adversary's actions because they will hurt him more than not taking action. China, too, realizes this answer and is attempting to find those same positions. Thus, currency exchange is proving to be the crossroads of current and future economic and financial clashes between the United States and China. America must seek better positions than China with respect to current account management, long-term total economic growth, financial connectivity with other nations, and currency value. To not maintain these positions, is simply to give up shares in the markets of world power and influence and thus to accept unnecessary risk in obtaining U.S. national security goals.

[33] William Odom and Robert Dujarric, America's Inadvertent Empire (New Haven: Yale University Press, 2004), 52.

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