CHAPTER SEVEN

Monetary Sterilization in China

Currency Sterilization

Foreign Competition

Steps of Currency Sterilization

The Impossible Trinity

Shadow Banks

Currency Sterilization

Currency sterilization
The practice of intervening in foreign exchange markets to fix the exchange rate and prevent growth in the supply of money.

China implements currency sterilization, which impacts the world economy and could eventually lead to damage in China itself.

Due to the size of China, currency sterilization gives China an undue advantage with regards to trade and impacts the global economy.

Copyright © Money, Banking and Financial Markets

Comparative Advantage and Foreign Competition

Comparative advantage
A country's ability to produce a good or service at a lower cost than the countries it trades with.

Driven by the country with the the lowest comparative cost.

Both countries that participate in this international trade practice end up with benefits.

Copyright © Money, Banking and Financial Markets

The Steps of Currency Sterilization

1 Intervention

Central banks purchase foreign currency from the commercial banking system

Paid for by issuing new reserves

Results in an increase in the domestic monetary base

2 Sterilization

Governments employ tactics to adjust the newly issued reserves in order to change the base money value.

Copyright © Money, Banking and Financial Markets

Currency Sterilization

Suppose the Chinese central bank has the following simple balance sheet:

Assets	Liabilities
Domestic Assets 4 trillion	Currency 2 trillion Reserves 2 trillion

To counteract the influx of foreign currency to the foreign exchange market -and to maintain the current value of their currency-the Chinese central bank purchases foreign currency:

Assets	Liabilities
Domestic Assets 4 trillion Foreign Currency (U.S.D) 200 billion	Currency 2 trillion Reserves 2 trillion New Reserves 200 billion

Copyright © Money, Banking and Financial Markets

Currency Sterilization

To counteract the influx of foreign currency to the foreign exchange market – and to maintain the current value of their currency – the Chinese central bank purchases foreign currency:

Assets	Liabilities
Domestic Assets 4 trillion Foreign Currency (USD) 200 billion	Currency 2 trillion Reserves 2 trillion New Reserves 200 billion

However, the central bank counteracts by swapping the new reserves for the newly issued domestic sterilization bonds, which serves to nullify the previous increase in reserves:

Assets	Liabilities
Domestic Assets 4 trillion Foreign Currency (U.S.D) 200 billion	Currency 2 trillion Reserves 2 trillion Domestic Sterilization Bonds 200 billion

Copyright © Money, Banking and Financial Markets

The Steps of Currency Sterilization

Capital Controls
Measures taken by the government, central bank, or other regulatory institutions to limit the flow of foreign capital into and out of the domestic economy.

China sterilizes currency with the purpose of maintaining its competitive manufacturing advantage

China artificially fixes the relative exchange rate of its currency to the U.S. currency and prevents inflation in the Chinese economy.

Copyright © Money, Banking and Financial Markets

The Steps of Currency Sterilization

China's process of sterilization impacts the global economy in a negative way.

By preventing a natural rate of appreciation, China has caused a great trade imbalance.

Copyright © Money, Banking and Financial Markets

The Impossible Trinity

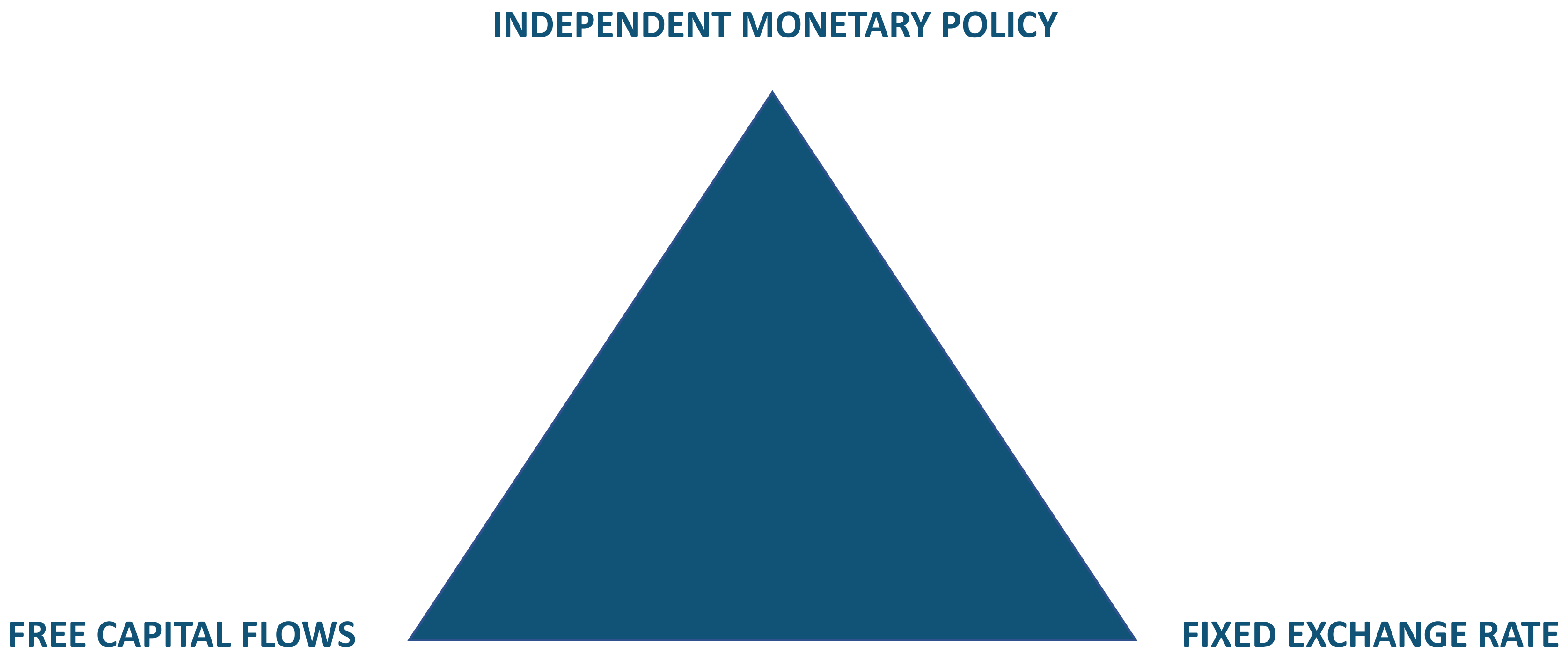
The impossible trinity states that it is impossible for a country to have monetary policy autonomy, a fixed exchange rate, and free capital flows all at the same time.

If a country wants to maintain a fixed exchange rate and allow the free flow of capital:

- The country will only be able to use monetary policy to offset changes in the supply and demand for currency in the exchange market
- The country cannot change their interest rate to react to other macroeconomic shocks, such as a fall in spending

Copyright © Money, Banking and Financial Markets

Figure 7.2: The Impossible Trinity



Copyright © Money, Banking and Financial Markets

Shadow Banks

Shadow banking
Lending and other financial services conducted by institutions that are not regulated or under conditions that are unregulated.

Shadow banks are a secondary banking system, and they operate in the shadow of the commercial banks.

Shadow banking imposes high rates:

- Operates without any regulatory system
- Severe punishment for default
- Facilitate the lending of funds between two parties in an unregulated manner

Copyright © Money, Banking and Financial Markets